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Grade 11

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The National Anthem of Sri Lanka

Sri Lanka Matha
Apa Sri Lanka Namo Namo Namo Namo Matha
Sundara siri barinee, surendi athi sobamana Lanka
Dhanya dhanaya neka mal palaturu piri jaya bhoomiya ramya
Apa hata sepa siri setha sadana jeewanaye matha
Piliganu mena apa bhakthi pooja Namo Namo Matha
Apa Sri Lanka Namo Namo Namo Namo Matha
Oba we apa vidya
Obamaya apa sathya
Oba we apa shakthi
Apa hada thula bhakthi
Oba apa aloke
Apage anuprane
Oba apa jeevana we
Apa mukthiya oba we
Nava jeevana demine, nithina apa pubudukaran matha
Gnana veerya vadawamina regena yanu mana jaya bhoomi kara
Eka mavakage daru kela bevina
Yamu yamu vee nopama
Prema vada sema bheda durerada
Namo, Namo Matha
Apa Sri Lanka Namo Namo Namo Namo Matha

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ஒரு தாய் மக்கள் நாமாவோம்
ஒன்றே நாம் வாழும் இல்லம்
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ஒற்றுமை சிறக்க வாழ்ந்திடுதல்
பொன்னும் மணியும் முத்துமல்ல - அதுவே
யான்று மழியாச் செல்வமன்றோ.

ஆனந்த சமரக்கோன்
கவிதையின் பெயர்ப்பு.



Being innovative, changing with right knowledge
Be a light to the country as well as to the world.

Message from the Hon. Minister of Education

The past two decades have been significant in the world history due to changes that took place in technology. The present students face a lot of new challenges along with the rapid development of Information Technology, communication and other related fields. The manner of career opportunities are liable to change specifically in the near future. In such an environment, with a new technological and intellectual society, thousands of innovative career opportunities would be created. To win those challenges, it is the responsibility of Sri Lankan Government and myself, as the Minister of Education, to empower you all.

This book is a product of free education. Your aim must be to use this book properly and acquire the necessary knowledge out of it. The government in turn is able to provide free textbooks to you, as a result of the commitment and labour of your parents and elders.

Since we have understood that the education is crucial in deciding the future of a country, the government has taken steps to change curriculum to suit the rapid changes of the technological world. Hence, you have to dedicate yourselves to become productive citizens. I believe that the knowledge this book provides will suffice your aim.

It is your duty to give a proper value to the money spent by the government on your education. Also you should understand that education determines your future. Make sure that you reach the optimum social stratum through education.

I congratulate you to enjoy the benefits of free education and bloom as an honoured citizen who takes the name of Sri Lanka to the world.

Akila Viraj Kariyawasam
Minister of Education

Foreword

The educational objectives of the contemporary world are becoming more complex along with the economic, social, cultural and technological development. The learning and teaching process too is changing in relation to human experiences, technological differences, research and new indices. Therefore, it is required to produce the textbook by including subject related information according to the objectives in the syllabus in order to maintain the teaching process by organizing learning experiences that suit to the learner needs. The textbook is not merely a learning tool for the learner. It is a blessing that contributes to obtain a higher education along with a development of conduct and attitudes, to develop values and to obtain learning experiences.

The government in its realization of the concept of free education has offered you all the textbooks from grades 1-11. I would like to remind you that you should make the maximum use of these textbooks and protect them well. I sincerely hope that this textbook would assist you to obtain the expertise to become a virtuous citizen with a complete personality who would be a valuable asset to the country.

I would like to bestow my sincere thanks on the members of the editorial and writer boards as well as on the staff of the Educational Publications Department who have strived to offer this textbook to you.

W. M. Jayantha Wickramanayaka,
Commissioner General of Educational Publications,
Educational Publications Department,
Isurupaya,
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2019.04.10

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Trade and Supporting Services

This chapter discusses the followings.

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1.2 Trade
  - Domestic trade
  - International trade

1.3 Supporting services

1.4 Banking services

1.5 Insurance services

1.6 Communication services

1.7 Transportation services





1.1 Introduction to trade and supporting services

A business can simply be defined as any activity satisfying the needs and wants of humans. Trade is the most important activity carried out by a business among all other activities. In order to make trade easy and efficient, supporting services are essential. The supporting services and trade are mutually related i.e. supporting services facilitate the growth of trade and trade facilitates the growth of supporting services.

1.2 Trade

Trade means buying and selling goods and services. In simple terms, trade can be explained as purchasing and selling of products. In trade, the ownership of a good is transferred from one party to another. This transfer occurs based on a monetary value.

Trade has expanded its scope into domestic and international areas. The categories of trade can be depicted as follows.

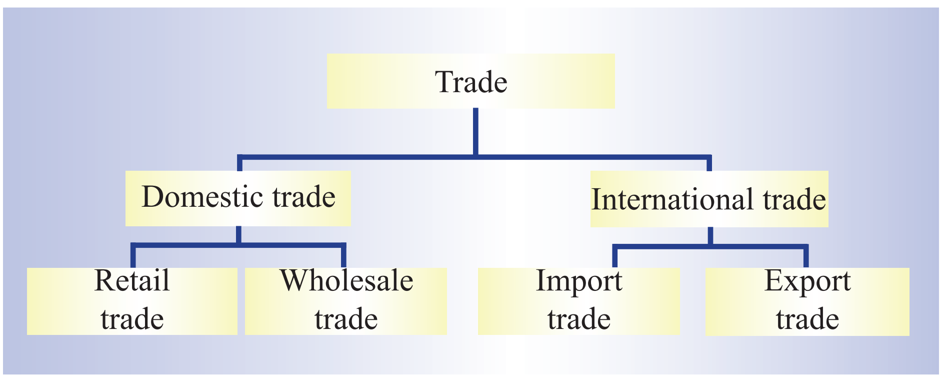


Figure 1.1- Categories of Trade

Domestic trade

Trading activities that occur among different parties within a country are domestic trade. In domestic trade, payments can be made in the currency used in that country. Domestic trade occurs in different ways.

- ☆ Retail trade
- ☆ Wholesale trade

Retail trade

Consumers require purchasing various goods and services in order to fulfill their wants. These goods are sold to them by the retailers. Accordingly, retail trade means selling goods and services for final consumption.

Example :-

When a student buys the required exercise books from the school co-operative or from another trading shop, trader has carried out a retail sale.

The person who carries out retail trades is known as a retailer. At present there are both large and small scale retail shops.

Characteristics of retail trade

- ✰ Selling goods and services for final consumption
- ✰ Supplying required goods in required quantities at the required time to consumers
- ✰ Close proximity to consumers

  Retail shops are available in any area in order to facilitate consumers to fulfill their needs. Retail shops are located closely to consumers.
- ✰ Providing a variety of goods

  Most of the retail shops sell various goods that fulfill the same need. Further more, at present there are retail shops that sell most of the goods required by a household.

Importance of retail trade

Retail trade is important as it provides the following services.

- ✰ Providing goods and services to consumers to fulfill their daily needs and wants
- ✰ Introducing new goods to consumers
- ✰ Providing goods on credit at times
- ✰ Supporting to improve the quality of goods by informing consumer feedback to producers

Types of retail traders

At present, there are small scale retail traders as well as large scale retail traders. Depending on their nature they can be categorized as follows.

- ✰ Fixed large scale retail traders

  Examples :-
  Supermarkets

- ✰ Fixed small scale retail traders

  Examples :-
  Groceries, Beauty salons

- ✰ Small scale mobile retailers

  Examples :-
  Retailers selling goods by visiting houses – Peddlers
  Retailers selling goods by traveling from fair to fair
  Mobile retail stores built on vehicles



Figure 1.2 - Retail business

Wholesale trade

Purchase of goods with the purpose of reselling is called wholesale trade. A seller who engages in wholesale trading activities is known as wholesaler.

Examples :-
Selling 50 kilograms of rice to a retailer
Selling a stock of cement to a contractor to construct a building

Characteristics of wholesale trade

- ✰ Purchasing goods for the purpose of reselling
- ✰ Often selling large quantities of goods in one transaction
- ✰ Selling a few selected items
- ✰ Unit selling price is relatively low
- ✰ Providing trade discounts i.e. reducing a certain percentage from the listed price of goods in a sale



Figure 1.3 - Wholesale business

Differences between retail trade and wholesale trade

Retailer and wholesaler are both middlemen engaged in distributing required goods and services to consumers. However, depending on how the business activities are conducted, the following differences can be observed between retail trade and wholesale trade.

Retail trade	Wholesale trade
The objective of retail trade is to sell goods for final consumption.	The objective of wholesale trade is to sell goods for the purpose of reselling.
Retailers sell different types of goods by understating consumer needs and wants.	Sells only one or limited types of goods.
Retail price is comparatively higher since retailers have to incur additional costs to resale and has to earn a profit as well.	The wholesale price is relatively lower compared to the retail price, as a result of selling in large quantities and trade discounts.
Goods are often sold at the listed price.	Trade discounts are given in wholesale trade.
Retailers are well aware of needs and wants of consumers, as they have direct contact with them.	Wholesalers do not have direct contact with consumers, they collect information about consumers, though retailers.

International trade

International trade is the trade carried out between two or more countries. In order to fulfill the needs of a country, both domestic and international products are required because a country is not self sufficient with goods and services required. Further, a country also needs to sell its excess production to other countries. Hence, almost all the countries are engaged in international trade.

There are two categories of international trade.

- ☆ Import trade
- ☆ Export trade

Import trade

Import trade is bringing goods from a foreign country or countries to this country.

Examples :-

Purchasing crude oil from Middle East countries
Purchasing automobiles from India

Export trade

Export trade is selling domestic goods to a foreign country or countries.

Examples :-

Selling Sri Lankan tea to European countries
Selling Sri Lankan apparel products to European countries

Activity 01

State whether the statements given below are **true** or **false**.

No.	Statement	True/ False
01	Purchasing of exercise books by a school co-operative shop to sell to students is a transaction relevant for retail trade.	
02	Selling ready-made garments manufactured in Sri Lanka to foreign countries is an example for export trade.	
03	Selling required goods for the daily needs of consumers in required quantities is a characteristic of wholesale trade.	
04	Buying required milk powder, fuel etc. for our country from foreign countries is an example for import trade.	
05	The difference between retail trade and wholesale trade lies in the purpose of purchase.	
06	Retailer often has direct contact with the consumers.	
07	The whole sale price of goods is often higher than the retail price.	
08	Selling rubber manufactured in Sri Lankan to China and bringing in Chinese machinery is an example for export trade.	
09	The retail trade involves a variety of goods whereas wholesale trade involves a limited types of goods.	
10	In our country, both retail trade and wholesale trade exist.	

1.3 Supporting services

Businesses engage in producing and distributing goods and services required by the humans. Business organizations require the support of different services in order to conduct business operations successfully. These facilitating services are known as supporting services. Today due to the revolutionary change that occurred in these supporting services, the world has become a global village.

Among the different supporting services available, the following selected supporting services are to be discussed.

- ☆ Banking services
- ☆ Insurance services
- ☆ Communication services
- ☆ Transportation services

1.4 Banking services

The services offered by the banks to businessmen to conduct their business activities successfully are known as banking services. The development in the banking sector today has immensely influenced on the success of businesses. Among the different types of banks existing today, the supporting services provided by commercial banks will only be discussed below.

Commercial banks

Commercial banks are the institutes providing various banking services while maintaining current accounts and other accounts. These are also known as licensed commercial banks due to the fact that they are operated under a license issued from the Central Bank of Sri Lanka. There are number of services offered by these banks to customers. Among them the following supporting services offered by commercial banks are discussed below.

1. Services related to deposits
2. Services related to electronic cash

1. Services related to deposits

The commercial banks maintain various deposit accounts in order to provide an opportunity for the businessmen, to deposit their excess money and to facilitate their business transactions.

These different types of deposit accounts are as follows.

- ☆ Savings accounts
- ☆ Fixed deposits
- ☆ Current accounts

Savings accounts

Businessmen as well as any individual can deposit money and withdraw money at any time from these accounts. The banks pay an interest at a certain rate for these accounts. Savings accounts can be opened individually or jointly by few individuals. Today, commercial banks have introduced different specialized savings accounts under different names other than the normal savings accounts.

Examples :-

Dhanayojana savings accounts
Savings accounts for women
Senior citizen accounts

Opening a savings account would provide various advantages for both businessmen and individuals. Given below are such advantages.

- ☆ Receiving security for money
- ☆ Earning an interest income
- ☆ Ability to deposit or withdraw money at any time
- ☆ Ability to withdraw money in an emergency
- ☆ Ability to transact via automated teller machines
- ☆ Ability to pay using debit cards

Opening a savings account

The process of opening a savings account is simple. In order to open a savings account it is required to submit, a duly completed savings account mandate of the bank, deposit slip, Know Your Customer (KYC) form and the tax declaration form along with the national identity card. In addition, it requires to deposit the minimum amount recommended by the bank or any amount greater than that. When all these requirements are fulfilled, the bank issues a pass book for the savings account holder. Deposits, withdrawals and the balance are recorded in this pass book.

Fixed deposits

The deposits that are maintained for a certain time period at a certain interest rate are known as fixed deposits. This deposit system is important as a way to deposit excess money and as a safe investment opportunity. There are several characteristics of a fixed deposit. They are,

- ☆ Maintaining the deposit for a certain period of time
- ☆ Varying interest rates depending on the amount deposited and the deposit period
- ☆ Receiving a relatively higher interest rate compared to normal savings accounts
- ☆ A certain percentage of the fixed deposit can be obtained as a loan by providing the fixed deposit as a collateral
- ☆ Interest will be accumulated monthly, at maturity or as per the agreed terms
- ☆ Bank gives a certificate mentioning the details such as the deposit date, deposited amount and maturity date



Activity 02

State whether the following statements are **true** or **false**.

No.	Statement	✓ / ✗
01	The interest on fixed deposit can be obtained monthly, at maturity or as per agreed terms.	
02	Fixed deposit certificate can be transferred to anyone.	
03	The interest rate of fixed deposit varies depending on the deposit period.	
04	A certain percentage of the fixed deposit can be obtained as a loan by providing the deposit as collateral.	
05	The interest rate paid on fixed deposits is higher than the rate paid on normal savings account.	
06	The conditions related to fixed deposits can be changed at the discretion of the bank.	
07	The money on fixed deposits cannot be withdrawn for a necessity before the maturity.	
08	The interest rate to be paid on savings accounts can be changed as per the banking regulations but the interest rate agreed to pay on fixed deposits cannot be changed during the deposit period.	

Opening a fixed deposit

When opening a fixed deposit, a duly completed fixed deposit mandate, deposit slip, Know Your Customer (KYC) form and a tax declaration form should be submitted along with the national identity card to the bank. When all these requirements are fulfilled, the bank issues a deposit certificate to the customer.

Current accounts

Amid different types of accounts maintained by a commercial bank, the current accounts are essentially the important type of account for a businessmen. Current account is an account which allows doing transactions via cheques.

Opening a current account

Current accounts can be opened individually, jointly or in the name of businesses. Most of the businessmen use current accounts in order to conduct their business activities easily. When opening such an account, an individual having an active current account in the respective commercial bank is required to introduce the new customer by completing the relevant application form (mandate). When opening a current account the relevant current account mandate, deposit slip and signature card need to be completed and submitted along with the national identity card.

Current accounts do not earn an interest. The bank will charge a fee if the balance in the current account reduces below a certain minimum level and for the other services provided by the bank to the account holder.



Activity 03

Collect the specimen of mandates to open the following accounts.

Savings account
Current account
Fixed deposit

01. Observe the information requested in each form.

02. Discuss with your friends and complete the specimen forms.

There are several advantages of maintaining a current account.

- ☆ Ability to make payments via cheques

  The ability to make payments via cheques make it easy and secure for the transactions done by the businessmen.

  Examples :-

  Employee salaries, electricity bills, insurance premiums can be paid via cheques

- ☆ Ability to obtain bank overdraft facilities

  Bank overdraft facilities can be obtained by getting permission from the bank to write cheques for a balance which exceeds the deposited balance in the current account. The amount by which the current account holder has been indebted to the bank by issuing cheques under the permission of the bank exceeding the balance in the account is known as the bank overdraft. The businessmen often use this facility to fulfill short term credit requirements.

- ☆ To collect remittances

  The money to be received by businessmen from other organizations and individuals can be collected directly to the current accounts.

  Examples :-

  dividends, interest income, remittances from debtors

- ☆ To activate standing orders

  There are certain payments that businessmen have to pay continuously for certain activities. A request can be made to the bank in writing by filling the relevant application form to pay a certain amount of money on certain time intervals continuously. The payments made by the bank according to such written requests are known as payments based on standing orders.

  Examples :-

  payment of insurance premiums, payment of loan installments

- ☆ Receiving a bank statement

  The bank sends a statement to the current account holder stating the transactions done through the current account. This is known as the bank statement. This statement can be obtained monthly, quarterly or as per the requirement of the account holder. Through this statement, the deposits, withdrawals and the balance in the account are informed. In addition, this statement helps to reconcile the reasons for the difference between the balance in the bank account of the business and the balance in the bank statement, if any.

Activity 04

State whether the following statements are **true** or **false**.

No.	Statement	True/ False
01	The report sent by a commercial bank to the current account holder stating the transactions done with the bank is known as the bank statement.	
02	The bank statement helps to rectify any errors or omissions in the bank account of the business.	
03	The closing balance in the bank statement is always similar to the closing balance of the bank account in the books of the businessman.	
04	The payments made by the debtors directly to the bank are known as debtors' remittances.	
05	The business is made aware of the cheque book charges and bank charges charged by the commercial bank through the bank statement.	

Cheques

A cheque book is issued by the bank when a current account is opened. A cheque is a written order given to the bank by the current account holder in order to pay a certain amount of money to the individual whose name is written on the cheque or to the bearer of the cheque.

There are three major parties involved in the transactions related to cheques. They are,

Drawer – The drawer is the person who writes and signs a cheque. Generally, the drawer is the current account holder.

Drawee – It is the bank of the drawer. The drawee is the bank in which the current account is maintained.

Payee – The person whose name is written on the cheque and has the right to receive the payment mentioned in the cheque is the payee.

Writing a cheque

A cheque is a legal document which can be used instead of cash when settling transactions. The factors to be considered when writing a cheque could be explained using an example as follows.

Examples :-

Prabhath Nawaratne is a sweets manufacturer and his current account is maintained at the Bank of Ceylon in Dikwella Branch. In order to improve the business activities, he bought equipments for a value of Rs. 80 000 on 16.01.20XX from Sarath Sirimanna. He intends to make the payment using a cheque.

The following specimen of the cheque is the cheque duly completed by him to make this payment. Observe it.



Figure 1.4 - Specimen cheque

Accordingly, the following are some important facts to be considered when writing a cheque.

01. Writing the date accurately
02. Writing the name of the payee clearly and accurately
03. Writing the value accurately both in figures and letters
04. Signing the cheque accurately by the drawer
05. If there are any corrections to be made on a cheque, those should be written clearly and be certified by the full signature of the drawer
06. Writing the relevant information on the cheque counter foil
07. Not writing anything on the Magnetic Ink Character Recognition space of the cheque
08. Crossing appropriately

The counter foil is the part that remains in the cheque book when a cheque is issued. The details of the transaction should be included here. The counter foil is the part which is linked to the above specimen cheque in a broken line. If there are any corrections made on a cheque, those should be mentioned on the counter foil as well.

Today, the cheques issued by every commercial bank have a Magnetic Ink Character Recognition space. The following numbers are printed respectively on this space.

A Cheque number
B Bank number
C Bank branch number
D Bank account number

Examine how these numbers are included on the specimen cheque given above.

Crossing a cheque

Crossing a cheque means drawing two parallel lines on the face of a cheque. Writing the name of a bank inside the two parallel lines or even without parallel lines is also considered as crossing. A cheque is crossed in order to provide more security for that cheque. Then, it cannot be encashed over the counter of a bank. Crossed cheque should be deposited to a bank account in order to obtain the money. Therefore, crossing a cheque ensures that the amount mentioned in the cheque will be given to the relevant person only.

A cheque can be crossed in two ways.

1. General crossing
2. Special crossing

General crossing

A general crossing is done by drawing two parallel lines on the face of a cheque with or without including a condition inside. The general crossing can be done in several ways. The following are some examples for commonly used general crossings.

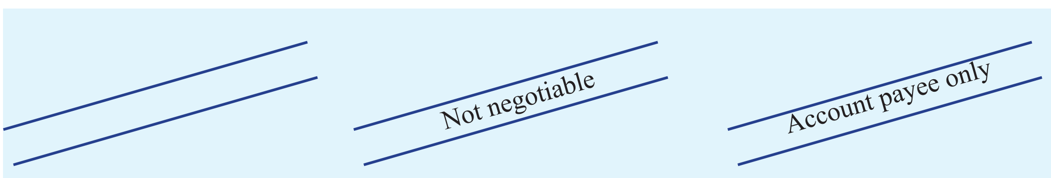


Figure 1.5 - Examples for general crossing

Special crossing

A special crossing is a crossing mentioning a name of a commercial bank written on the face of a cheque inside two parallel lines or without parallel lines. It can be done in the following ways.

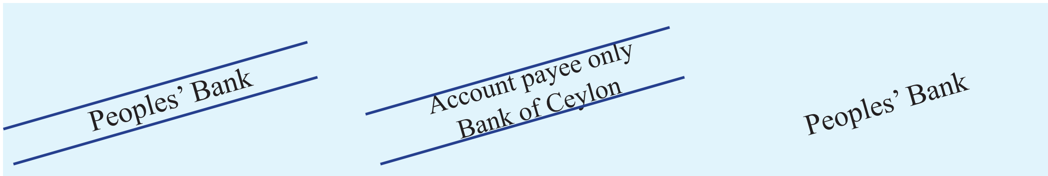


Figure 1.6 - Examples for special crossing

A cheque crossed in this way requires to be deposited in an account in the named bank in the crossing.

Endorsing a cheque

Endorsing a cheque means writing the name of the payee, as mentioned on the face of the cheque, at the back of it by the hand writing of the payee himself. A cheque can be endorsed when a businessman transfers a cheque that he has received to another party for a transaction or when depositing a cheque into a bank account. Endorsing a cheque ensures that a person has the true title for that cheque.

Activity 05

Assume that you are a businessman distributing rice and assume that your friend is a rice supplier. If you have decided to pay by cheque for a stock of rice that you have purchased from your friend,

01. Design a specimen of a cheque.
02. Name the information required to fill the cheque.
03. Complete the cheque and cross the cheque in order to provide complete security.
04. Discuss with your friend, the advantages of transacting via cheques than transacting via cash.

2. Services related to electronic cash

A payment for buying a good or a service can be made using cash or any other payment settlement method. Until recent times, the businessmen often used coins, notes and cheques for settling the payments. At present, banks have introduced different services to the customers using electronic communication technology. These services are known as services related to electronic cash.

Electronic cash (e-cash) is an electronic payment settlement method which can be substituted for cash and cheques. Let us discuss the commonly used electronic cards given below.

- ☆ Credit cards
- ☆ Debit cards
- ☆ Automated Teller Machine cards (ATM)

Credit cards

These are a type of card issued by commercial banks on credit basis. It is not essential for a customer to have a bank account in order to obtain such a card. A credit card can be submitted for a recommended trade organization to buy goods and services on credit basis up to a certain amount. In addition, the credit card can also be used to withdraw cash up to a certain limit from automated teller machines. The bank will later inform the credit card holder the credit balance obtained using the credit card. The credit card holder is liable to pay that credit balance to the bank.

The transactions related to credit cards occur via automatic electronic networks. The international credit card networks are Visa, Master, American Express and Discover. The commercial banks issue credit cards with the support of these credit card networks. The following are some examples for such credit cards.

Examples :-

Bank of Ceylon – Cey Bank Visa
Peoples' Bank – Peoples' Visa

Debit cards

Debit cards are the cards issued by the commercial banks to their customers facilitating them to make payments directly using the cash available in the bank account. It is required to have a bank account to obtain a debit card. Goods and services can be purchased using these cards up to the cash balance available in the bank account. When goods and services are purchased using these cards, the relevant amounts will be directly debited to the bank account of the customer.

The special fact about the debit cards is that it transfers the relevant value of a transaction by reducing it from the customers' account and by transferring that to the seller's account via the bank. In addition, it is possible to withdraw cash in the account from the automated teller machines by using these debit cards.

The following are some examples for debit cards.

Examples :-

Sampath Bank – Set Card
Commercial Bank – Cat Super Card

Automated Teller Machine (ATM) Cards

These cards are issued to customers by a commercial bank in order to provide services similar to that of normal savings account. Money can be withdrawn from a savings account using automated teller machines that are operated via a computer. These cards can be used to transfer cash from one account to another account as well. The following are some examples for the automated teller machine cards issued by commercial banks.

Examples :-

Peoples Bank – PET
Bank of Ceylon – CEYNET
Sampath Bank – SET



Figure 1.7 - Electronic money

Importance of the services related to electronic cash

The following advantages can be achieved by using electronic cash for the transactions.

- ☆ Instantaneity
  The services related to electronic cash are efficient and methodical. Since all activities are performed via electronic media, banks and customers can save time by doing their activities easily and quickly.
- ☆ Minimizing the risk
  The risk of losing cash while carrying it is reduced due to these services.
- ☆ Recording information automatically
  Since all activities are performed automatically, transactions are recorded easily and accurately.
- ☆ Ability to transact at any time of the day

Limitations of services related to electronic cash

- ☆ Risk of data being destroyed
  Problems can arise due to the risk of data being destroyed as a result of technical errors.

- ☆ Risk of being exposed to new types of electronic frauds

  Example :-
  A person can use personal Identification Number (PIN) of another person fraudulently to do transactions

- ☆ Incurring an extra cost
  When the payments for a credit card are delayed, a penalty for delayed payments and high interest rates will be charged.

- ☆ Inability to use for payments at certain shops



Activity 06

The following are some instruments that can be used for making payments.

A note of Rs. 2 000
A cheque
A credit card
A debit card

01. Briefly explain each instrument mentioned above.

02. Prepare a table stating the advantages and disadvantages of using each of the above instruments for settling payments.

1.5 Insurance services

Every individual as well as every businessman has to face risks. It is impossible to identify with certainity when or where those risks would occur. Instant fires, storms, floods, tsunamis, earthquakes, accidents and riots are some such risks.

In order to face to these risks a systematic method should be adopted. Insurance institution give systematic method to minimize these risks.

The basis of insurance is accumulating risk. The insurance collects premiums from individuals who anticipate different risks and pays compensation from that common fund to those individuals who have faced these risks in definite. Insurance accumulates the risks of all into a single insurance funds hence insurance is known as a pool of risks.

Insurance is established to share financial losses among the participating individuals of that insurance fund, of one or few individuals who have worn a risk with difficulty. Insurance is a pool of risks where the losses of one party are shared collectively. This is an agreement between two parties.

Parties involved in insurance

1. First party – The party who obtains the insurance coverage i.e. the insured
2. Second party – The party who provides the insurance coverage i.e. the insurer. The insurer is the insurance company.
3. Third party – All the other parties and properties will be affected by an insurance contract. For example, the passengers and other vehicles on the roads will become the third party when a vehicle is insured.

Principles of insurance

Insurance service is built on insurance principles of which a few are mentioned below.

- Insurable interest
- Utmost good faith
- Indemnity

Insurable interest

The legal right to obtain an insurance coverage for a life or for a property is known as insurable interest.

Example :-

Husband and wife have insurable interest for each other's life.

In property insurance, the legal owner of such property has an insurable interest.

A creditor has an insurable interest over the life of the debtor up to the value of the loan.

Utmost good faith

This principle states that both parties to the insurance contract should disclose all the relevant information accurately for the contract. The parties involved in the contract are the insurer and the insured. The insurer is the insurance company and the insured is the party who has obtained the insurance coverage. If either party does not disclose any important information it will be a breach of utmost good faith. Then both parties have the legal right to cancel the insurance contract.

Indemnity

This principle states that if a loss occurs to an insured property, the compensation paid should be sufficient only to reinstate the damage to the previous state. This principle does not apply to the life insurance.

Example :-

When a motor vehicle having a value of Rs. 2 000 000 is insured for the same value, a compensation of Rs. 500 000 can only be obtained for a damage valued Rs. 500 000.

Life insurance

Insurance provides a vital service for individuals. If an insured dies prematurely, his dependents can obtain the compensation from life insurance. Life insurance covers the risks associated with the life of an individual. Life insurance is also termed as life assurance.

Accidents, health issues, surgeries undergone by individuals and hospital charges etc. can also be included as additional covers into the life insurance contract.

Importance of life insurance

- ✰ Can be used as a method of saving or investment
- ✰ If the insured survives until the policy matures the insured can obtain the insured value and other benefits
- ✰ If the insured dies prematurely, the named dependents can obtain the compensation
- ✰ Can obtain financial assistance in case of marriages and education of children
- ✰ Can be used as a collateral when obtaining loans from financial institutions

Property insurance

Property insurance is the insurance obtained to cover damages that might occur to property such as buildings, machineries, vehicles and inventories.

Insurance companies issue various types of insurance policies under this insurance.

Example :-
Fire insurance, Motor insurance, Marine insurance, Insurance for natural disasters

Importance of property insurance

- ✰ Cover financial losses arising in an organization from the various risks.

Example :-
threat of fire, burglary, occupational hazards

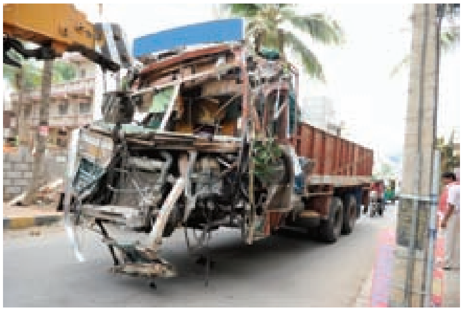


Figure 1.8 - A vehicle met with an accident

- ✰ Facilitate in conducting business operations continuously

Since the insurance pay compensation for the massive damages faced by businessmen, it facilitates a business to be reinstated to the previous state and continue the operations.

- ✰ Supports both in domestic and foreign trade activities

Example :-
Marine insurance, Goods in transit insurance, Export credit insurance, Cash in transit insurance

Differences between life insurance and property insurance.

The following table provides several differences between these two insurances.

Life insurance	Property insurance
The value of the policy depends on the risk of the life and the insured's ability to pay.	The value of the policy depends on the monetary value of the property.
Since the damage to the life cannot be reinstated, the principle of indemnity does not apply.	Since the compensation can be paid only to reinstate the property, the principle of indemnity does apply.
Benefits such as bonuses, interests etc will be received in addition to the insured value.	Not entitled for such additional benefits.

Activity 07

State whether the following statements are **true** or **false.**

No.	Statement	True/ False
01	Life insurance covers the risks related to the life of an individual.	
02	Insurance collectively shares the loss of a participating party to an insurance fund among all participating parties of the fund.	
03	When a property or a life is insured, the risk of those will be eliminated.	
04	The value of a property insurance will be determined by the willingness and the ability to pay of an individual.	
05	When obtaining an insurance policy, the insured and the insurer should disclose all the relevant information.	
06	When a vehicle is insured for the value of Rs. 2 500 000, as compensation the entire Rs. 2 500 000 can be obtained in the case of a loss estimated to Rs. 1 000 000.	
07	Indemnity principle does not apply for life insurance.	
08	An individual has the legal right to insure any relative.	

1.6 Communication services

Communication is an important supporting service requires for the successful operation of a business. Communication is known as the exchange of messages, information and ideas among different parties through any medium.

Importance of communication for business activities

Today, a revolutionary growth can be observed communication parallel to the development of information technology. Accordingly, different communication methods are in use. In this competitive market, communication technology has become an essential service for the success and survival of businesses.

The communication is important to obtain required information for the business as well as to provide information to the various stakeholders of the business. Since we are now living in an information technology era, communication is vital for businessmen in order to make different decisions.

Communication can be divided into two main parts depending on the various stakeholders.

01. Internal communication
02. External communication

Internal communication

This means communicating messages, information and ideas via various mediums between different parties within an organization. This communication always occurs among owners, managers and other employees. Since internal communication is required when performing the business activities, the frequency of occurrence of this communication is very high. Further, in internal communication the distance between the sender and the receiver is minimum.

External communication

External communication is the communication of a business with external individuals and external organizations. This communication occurs with individuals such as different customers, suppliers, retailers, wholesalers and agents and with governmental and other organizations. The external communication occurs in less frequency compared to internal communication. Further, the distance between the sender and the receiver is relatively high.

Different communication mediums used by businesses

A business uses different communication mediums for communicating with internal and external parties. Depending on their nature the communication mediums can be categorized as follows.

Nature of the communication	Examples for communication mediums
Verbal	Meetings, Discussions, Workshops, Conferences, Telephone conversations
Written	Letters, Notice boards, Reports, Hand bills, Newspapers, Magazines, Banners, Posters
Electronic	Loud speakers, Digital display boards, E-mail, Fax, Internet, Broadcasting medium, Telecasting medium, Social web sites
Codes and signals	Road signals, Universally accepted signs, Bell

Although the above communication mediums are categorized broadly into four, most of the time they cannot be limited only to one category depending on the nature of the communication.

Example :-

Telephone conversations – Electronic/ Verbal
E mail – Electronic/ Written
Skype – Electronic/ Verbal/ Written



Figure 1.9 - Mobile phones

Process of communication

Communication is not a single activity but a process comprised of few common elements.

- Sender - the person or the institution sending the message
- Message - information conveyed by the sender
- Medium - the communication medium used for sending the message
- Receiver - the person receiving the message
- Response - how the receiver act on the message
- Feedback - reply, either verbally or non-verbally, regarding the message sent from the receiver to the sender

This process can be explained by the figure given below.

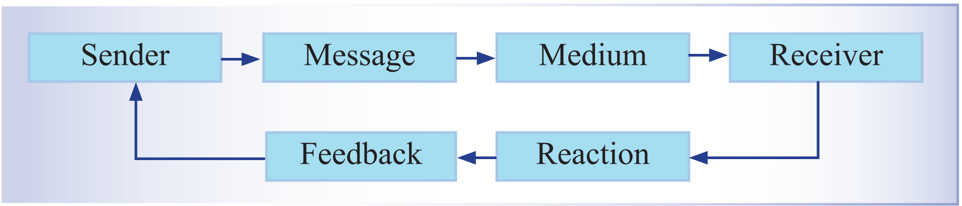


Figure 1.10 - Process of communication

Factors to be considered when selecting an appropriate medium of communication

Any individual or an institution need to consider several factors when selecting a communication medium in order to carry out communication activities productively and effectively.

- Appropriateness

  An appropriate communication medium requires to be selected depending on the information expected to be communicated and the objectives of communication.

- Speed

  An appropriate communication medium needs to be selected depending on how quickly the information to be delivered.

- Cost

  The total cost for communication is an important factor to be considered. Due to the advancement in technology, low cost communication methods have been created.

  Example :-

  Short Message Service (SMS)

- Clarity

  The receiver should be able to understand the message clearly.

- Easy to use

  The communication medium should be easy to use depending on the knowledge and skills of the sender and the receiver.

Activity 08

Communication is important not only in businesses but also in education. State the facts to prove this statement.

1.7 Transportation services

Transportation can be explained as moving goods and passengers from one location to another location. Transportation is an essential service not only for the business activities but also for the development of the entire society. Nowadays, business activities have become efficient due to the development in the transportation services.

Elements of transportation

Transportation is not just a fleet of vehicles. It is a system that consists of several elements. Those elements are given below.

- ☆ The way
- ☆ Transportation medium
- ☆ Power
- ☆ Terminal



Figure 1.11 - A scenery of a harbour

☆ The way

This means different ways used for transportations. These ways can be categorized mainly as roads, railways, water ways and air ways. Some ways are man made whereas some are natural.

☆ Medium

Different types of vehicles and crafts used in different transportation ways are known as medium of transportation.

Examples :-

Buses, Trains, Ships, Aero planes

☆ Power

The energy used to run transportation medium is known as the power. Today, different types of energies are used due to the advancement in technology.

Examples :-

Solar power, Gas, Electricity, Fuel, Hybrid technology

☆ Terminal

Terminal or a station is the place where the medium of transportation is handled. The terminals are known in different names.

Examples :-

Bus stop, Port, Railway station, Air port

The advancement in the elements of transportation mentioned above enables the development of the entire field of transportation.

Factors to be considered when selecting an appropriate transportation medium

Businessmen consider the following factors when selecting an appropriate medium of transportation.

- ✰ Nature of the good

  According to the factors such as the nature of the good, existence, expiry period, weight and value, the transportation medium used will be varied.

  Examples :-

  Using fuel tanks to transport fuel

- ✰ Cost of transportation

  The total cost of transportation is an important factor to be considered. The ultimate result of higher transportation cost is that it will increase the price of a good.

- ✰ Capacity

  Capacity is the load of goods that can be carried by a medium of transportation in one instance. A businessman should select an appropriate transportation way and a medium based on the load of goods that is expected to be transported.

  Examples :-

  A bigger load of goods can be transported via train than a lorry

- ✰ Security

  The medium of transportation should be able to transport the goods securely to its destination.

- ✰ Speed

  Transporting quickly is vital when transporting certain goods, raw materials as well as employees. Since fast transportation saves time, it provides an opportunity to conduct business activities efficiently.

- ✰ Being common

  A businessman should have the ability to select a medium of transportation without much difficulty or effort. If any medium of transportation is not commonly available, although it is cost effective, then attention needs to be paid to another medium that can be obtained easily.

  Examples :-

  Trains cannot be used as a medium of transportation at any given time since trains are available only at a certain time and on certain routes

How transportation contributes to the effectiveness of business activities

Transportation plays a significant role as a supporting service in order to conduct business activities effectively. Today, it contributes to expand the market as well. Given below are some business activities carried out using transportation services.

- ✰ To obtain resources required for production
  Transportation services are used to obtain raw materials, machinery and equipment safely and on time. Some resources are obtained locally as well as globally.

- ✰ To deliver finished goods to the markets
  Transportation services are required for distributing finished goods to various local and global markets.

- ✰ To transport employees
  Employees should be present at work on time in order to conduct business activities efficiently. Some businesses provide transportation facilities to their employees.

- ✰ To deliver goods to the consumer
  Some businesses producing goods such as furniture, electronic equipments and food and beverages etc provide delivery facilities to the consumers by delivering the purchased goods to their home.

Ways of transportation

Transportation ways are different routes and roads used for accomplishing both business and personal transportation activities. The following are some ways of transportation.

- ✰ Roads
- ✰ Rail ways
- ✰ Water ways
- ✰ Air ways

Road transportation

This means the transportation done using roads on the land. The road system has an important place within the transportation system of Sri Lanka. The transportation using roads has following advantages and disadvantages compared to other ways of transportations.

Advantages of road transportation

- Can be used up to the destination

  Road transportation is the transportation way which can be used up to the destination.

- Can be used at any time

  Businessmen as well as individuals can use roads for transportation at any time of the day.

Disadvantages of road transportation

- Delays due to traffic congestion

  Delays can occur due to road traffic because of the large number of vehicles.



Figure 1.12 - A traffic congestion

- Relatively a higher rate of accidents on the roads

  Since some drivers do not obey road rules, there is a high risk of have road traffic accidents.

- Impact on the environment

  Environmental pollution occurs due to the gasses emitted and other solid wastes from vehicles.

Railway transportation

Railway transportation is the movement of goods and passengers using rail roads. Sri Lanka has a limited number of rail way lines such as Coastal Railway Line, Upcountry Railway Line, Northern and Kellani Valley Railway Line. The railway transportation has following advantages and disadvantages compared to other transportation ways.

Advantages of railway transportation

- Ability to transport a heavy load of goods and passengers at once

  Since rail way transportation can utilize a greater number of rail road cars. It has a high capacity to transport passengers and goods in one instance compared to road transport.

- ☆ Special transport services for long distances

  These trains provide special facilities such as observation cars, sleeping cars, air conditioned cars and restaurants etc.

- ☆ No traffic on the railway roads

  There is no traffic congestion on rail way roads since trains run according to a time table and only a limited number of trains are available.

Disadvantages of railway transportation

- ☆ Often cannot be used up to the destination

  Since rail way lines are not spread across the island cannot be used up to the destination. Therefore, another transportation medium has to be coupled with the rail way transportation.

- ☆ Passengers cannot use rail way services at any time they require since trains run only according to a time table

- ☆ If an accident occurs, it takes a long time to restore the rail ways

  Compared to other ways break down in signal posts, rail way roads or any delays arising due to other road accidents consumes a long time to restore.

Air way transportation

Air way transportation is the movement of goods and passengers via air ways. A country use air transportation for both internal and international transportation activities.

The air way transportation has following advantages and disadvantages in comparison to other transportation ways.

Advantages of air way transportation

- ☆ Comparatively high speed

  It is suitable for transporting perishable goods. In addition, any individual such as businessmen, government officials often use air transportation when they want to go abroad for urgent matters.

- ☆ Higher comfort for passengers

  Passengers are facilitated with comfortable seats, television and internet facilities while traveling.

☆ Facilitate international trade

Facilitates in obtaining required raw materials and finished goods for businesses and distributing local goods to global markets.

Disadvantages of air way transportation

☆ High cost for transportation

Air way transportation cost is comparatively higher than the cost of other transportation ways.

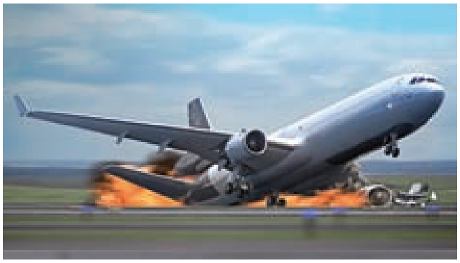


Figure 1.13 - A scenery of an air crash

☆ Severity of an accident is high

If an accident occurs on the air ways, the severity of the damage is high.

☆ Cannot transport heavy goods

Often it cannot be used for transporting heavy goods.

Water ways transportation

This is the transportation done using water ways such as oceans, rivers and canals etc. Water ways transportation can be used for both internal as well as international transportation activities of a country. Our country uses ocean transportation more commonly. The water ways transportation has following advantages and disadvantages compared to other transportation ways.

Advantages of water ways transportation

☆ Can transport a large quantity of goods and passengers in one instance

Transportation mediums such as ships and rafts can transport a load of goods and passengers at once.



Figure 1.14 - A cargo ship

☆ Comparatively lower cost of transportation

Cost of transportation is lower when compared to air way transportation.

☆ Facilitate international trade

The development of ocean transportation has facilitated the growth of international trade.

☆ Can transport heavy goods

Ships can transport heavy goods in large quantities compared to air ways transportation.

Disadvantages of water ways transportation

☆ Time consuming for transporting goods

Since the speed of ships is low, it consumes a long time to transport to distant destination.

☆ Inability to reach every destination

As certain countries and certain areas in the world are not connected to an ocean, this transportation method cannot be used.

Activity 09

The following are examples for some events related to the transportation sector in Sri Lanka. Name the relevant element of transportation for each event.

01. Expanding the Colombo harbor
02. Reducing the prices of diesel, petrol and kerosene
03. Planning to develop a new road between Matara – Katharagama
04. Ceylon Transportation Board importing 200 small buses in order to use in the transportation in rural areas
05. Introducing a new solar power system to obtain power to run vehicles
06. Building two new rail way stations with all the facilities
07. A company buying three new air planes
08. Repairing the damaged roads in rural areas by using concrete

Activity 10

The following are four incidents using transportation services.

Distributing dry food for people suffering from floods in the Eastern area
Importing ten train engines to Sri Lanka from China
Going to Colombo from Galle for an emergency
Bringing a load of salt to Colombo from Jaffna

01. State different transportation ways that can be used for each instance in the activity above.
02. State two mediums running in each transportation way above.
03. Select the most appropriate transportation medium for each activity and explain the reasons for selecting that medium.

Chapter 02

Management

This chapter discusses the followings.

2.1 Introduction to management

2.2 Functions of management

- Planning
- Organizing
- Leading
- Controlling





2.1 Introduction to management

Current economic and social development has resulted a great number of businesses that fulfill the expanding human needs and wants. These businesses operate with an expectation of achieving specific objectives while satisfying human needs and wants.

Although there are large number of businesses, all businesses are not operated successfully. There are situations where some businesses are closed down due to their unsuccessful business operations. The success or failure of a business depends on the extent to which a business achieves its objectives. If a business is to achieve its expected objectives it has to use its resources productively.

In general, the nature of the resources are that they are limited compared to the unlimited human wants. Businesses also face this limitedness of resources. Since the resources such as labour, raw materials, cash etc owned by a business are limited, business should have the ability to utilize such resources to obtain the maximum benefit while minimizing the wastage.

Therefore, a business should always employ methods which enables it to use limited resources in an effective manner. It means that a business should aim at obtaining a higher level of output with limited resources. In a business this objective is achieved through management.

Management is the process of planning, organizing, leading and controlling the resources owned by a business in order to achieve objectives of a business efficiently and effectively.



Effectiveness means using resources to achieve the expected objectives and efficiency means using resources to obtain the maximum output from minimum resources.

2.2 Management processes

Management is a continuous process which consists of four main processes or management functions. They are,

01. Planning
02. Organizing
03. Leading
04. Controlling



Figure 2.1

Each process of management can be introduced as follows.

Planning

Planning is the process of determining the objectives of a business and determining the activities to achieve these objectives.

Example :-
A business constructing and selling houses plans to earn a profit by selling quality houses to its consumers



Figure 2.2

In order to achieve this objective, the following activities can be planned.

- Determining how the construction and selling will be carried out
- Determining the required resources and employees
- Determining how to obtain the required resources

Organizing

Organizing is the process of distributing required resources, job roles and tasks in order to implement the planned activities, to achieve the objectives of a business.

In order to implement the plan mentioned in the above example, the activities can be organized as follows.

* Appointing managers responsible for construction and sales activities of the business
* Allocating employees for each section and required resources to both managers and employees



Figure 2.3

Leading

Leading is the process of directing human resources appropriately when implementing the planned process. They should be led by giving the required information and instructions and motivating them to do the relevant activities.

The leading process of the above mentioned example can be implemented as follows.

* Production manager and sales manager providing the required information and instructions to their employees
* Motivating employees to do their jobs appropriately by maintaining good professional relationships with them



Figure 2.4

Controlling

Controlling is the process of finding out whether the business activities are implemented as planned and if not, identifying errors and taking necessary measures to correct them.

The controlling process of the above mentioned example can be done as follows.

* Finding out whether houses are constructed with the expected quality
* Finding out whether those houses have been sold as planned
* If construction and selling have not been carried out as planed finding out reasons for that
* Planning necessary measures to avoid such errors

Activity 01

Following statements are regarding the management process. If each statement is 'true' put ' ✔ ' or if 'false" put '✘'.

No.	Statement	✔ / ✘
01	A business needs management to obtain maximum benefits from limited resources.	
02	Every business operates in order to achieve a specific objective or several objectives.	
03	In developed countries in the world, resources available for satisfying human needs are unlimited.	
04	Management is a continuous process of consisting of several functions.	
05	The planning process includes determining objectives of a business as well as determining ways for achieving the objectives.	
07	Organizing consists of activities related to delegating tasks to achieve planned activities, appointing individuals for those tasks and delegating responsibilities and duties for them.	
08	Leading means managers guiding their employees on the tasks that they have to perform.	
09	Controlling means finding whether the activities have been implemented as planned and if not, finding reasons for that and re-planning to correct them.	

Activity 02

The Commerce Society of Kawanthissa Central College has conducted the Commerce Day successfully. Several activities of the adopted process for the event are given below.

- Determining a theme for the Commerce Day
- Determining a date, time and venue
- Determining the activities to be done for the Commerce Day
- Appointing committees depending on the activities
- Appointing leaders for the committees
- Nominating members for committees
- Determining how to obtain the required funds and resources
- Allocating funds and resources to the committees.
- Committee leaders providing the required instructions for their members
- Committee leaders employing their members in the respective activities
- Finding out whether each committee functions accordingly.
- Finding out whether there would be any draw back that would occur on the Commerce Day and taking necessary measure to overcome them
- At the end of the Commerce Day, preparing a report analyzing the reasons for the success and draw backs

Categorize each activity given above under each process of the management.

Chapter 03

Marketing

This chapter discusses the followings.

3.1 Introduction to marketing

3.2 Target market

3.3 Marketing mix



3.1 Introduction to marketing

As a consumer, you expect a business to supply quality goods and services at a reasonable price in order to satisfy your needs and wants. A business performs various activities in order to provide this expected service and marketing is one of those activities. Accordingly, marketing is a process which links the process of supplying required goods and services to fulfill consumer needs and wants.

Marketing consists of activities from the manufacturing of goods until they are distributed to the consumers as well as services provided after sales.

Accordingly, the marketing concept can be simply explained as follows.

Marketing is the process of creating and offering a valuable product to satisfy human needs and wants.

The activities belong to marketing are,

- Creating a good or service that can better satisfy a human need or a want
- Introducing the designed good or service to the consumers in an attractive manner
- Marking a reasonable price
- Distributing a good or service to the consumer in the most simple and appropriate way
- Finding out consumer feedback regarding the good or service and providing after sales services



Figure 3.1

Marketing is an important concept for businesses because a business will be successful through satisfying consumer needs and wants. Marketing is essential for a business in order to attract new customers as well as to retain the existing customers with the business.

3.2 Target market

Market is an important factor in marketing. Any form in which a buyer and seller meets is considered as a market. A market can be a physical location or a 'market space' which is connected via the internet. Since there is large number of buyers with different wants in the market one seller cannot satisfy all the buyers as well all the wants. Therefore a business selects a portion of consumers from the entire market that can satisfy best.

The share of the market consisting of consumers that a business can satisfy in a more attractive and profitable way is the target market.

Examples :-

Printing and selling a model question paper book for the students reading for G.C.E. Ordinary Level

Manufacturing and selling specialized food for diabetic patients

3.3 Marketing mix

Marketing mix is a set of variables used to achieve the marketing objectives of a business within a target market. The marketing mix consists of four variables which can be controlled by the owners of a firm. The four variables are known as 4 P's.

1. Product
2. Price
3. Place
4. Promotion



Figure 3.2

Product

Product is anything provided to the market in order to satisfy needs and wants. Basically, a good or a service is considered as a product.

Think about different things that you use to fulfill your needs and wants. Food and beverages, clothes, footwear, books, the service of teachers and doctors as well as listening to a song, watching a movie or a drama etc are also considered as products.

Price

In marketing, price is the amount of value expected to be charged from consumers for a good or a service. This is a cost from the view point of a consumer. Price is the major factor that will be considered by a consumer when buying a product. As well as that, price is the only variable among other variables in the marketing mix that generate an income for the business.

Place

Products must be delivered to the consumers to satisfy human needs and wants. The activities related to the distribution of products to the consumers are known as place. A manufacturer can use different methods to distribute products to the consumers.

Examples :-

Direct distribution

Manufacturer himself distributing products to the consumer

Distributing via intermediaries

Manufacturer distributing products via intermediaries such as wholesaler, retailer etc

Promotion

You may have seen businesses using different strategies to increase its sales. Advertising the products, distributing free samples, conducting workshops to introduce products, providing sponsorships for sports events and dramas etc are some of such activities. Accordingly, these different strategies used by businesses to increase sales are known as promotion.



Figure 3.3

The significant factors to be considered under each variable of the marketing mix explained above can be mentioned separately. Accordingly each variable in the marketing mix consists of different instruments. Those can be illustrated in a figure as below.

Marketing mix

Product	Price	Place	Promotion
Quality	Listed price	Distribution	Advertising
Features	Discounts	Ware house	Personal selling
Pattern	Allowances	Transportation	Public relations
Packaging	Credit terms	Coverage areas	Sales promotions
Brand name	Payment methods		

Figure 3.4 - Items for each variable in marketing mix



Activity 01

1. Read the following statements and put ' ✓ ' if it is correct and put 'x' if it is incorrect.

No	Statement	✓ / x
01.	Marketing concepts focuses on satisfying human needs and wants.	
02.	Sellers provide different products to the market in order to satisfy needs and wants of consumers.	
03.	Market is a certain location where buyers and sellers meet.	
04.	There are certain instances where the manufacturer directly distributes goods to the consumers.	
05.	Whole seller acts as an intermediary in the distribution process of goods.	
06.	The marketing process ends when a product is delivered to the consumer.	
07.	Advertising is a strategy used for promoting a product.	
08.	When deciding the method for promoting a product, the consumer segment which demands that product should be considered .	

Activity 02

List down 10 products you use for your daily consumption. Write down their prices, the place from where you bought and the strategies used to promote these products in a table as per the example given below.

No.	Product	Price	Place	Promotion
1.	Carbon pen	Rs. 15	Retail shop	Television advertisements

Activity 03

01. Name a product which you think that should be produced useful to fulfill a need in your area.

02. What factors should be considered when determining a price for that product?

03. What are the different methods that can be used to distribute that product to consumers?

04. Design a suitable television advertisement or a news paper advertisement to promote that product.

Chapter 04

Financial Statements of a Business

This chapter discusses the followings.

4.1 Introduction to financial statements

4.2 Profit or loss statement

4.3 Statement of financial position



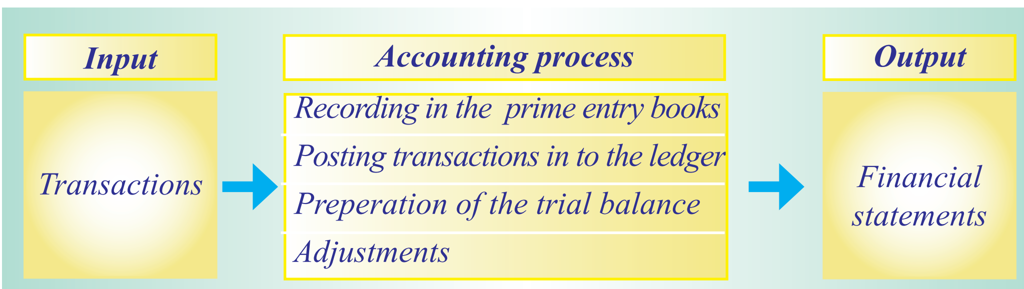
4.1 Introduction to Financial Statements

In the accounting process, the business transactions are first recorded in to the prime books and then posted in to the ledger accounts. Then the ledger accounts are balanced and taken in to the trial balance. This process has been already discussed in detail in the grade 10 study text.

The objective of any business is to earn profits from their business activities. Therefore it is worthwhile to see whether there is an adequate operational profit to continue the business. Also it is important to see the financial position of the business reflected through the assets, equity and liabilities. Such information assists in making decisions for the future of the business.

Accordingly, to obtain an understanding on the financial performance of the business during a specific period and the financial position as at a particular date of the business, the financial statements need to be prepared. The financial statements are prepared to identify the operational result and the financial position of the business.

Financial Statements of the business are prepared for specified period of time. This is known as the "Accounting Period" and it is generally considered as twelve months period of time. The financial statements are regarded as the output of the accounting process.



The financial statements are prepared for various business organizations. This chapter focuses only on preparing two financial statements for a sole proprietor or sole trader type of business organization.

A sole proprietor business prepares two main financial statements to ascertain the operational results and financial position for a given accounting period as follows;

01. Profit or Loss Statement

02. Statement of Financial Position

4.2 Profit or Loss Statement

Profit or loss statement is prepared by a business organization to calculate the profit or loss earned during a particular accounting period. This statement was also known as the Statement of Income in the past, but now it is known as the Profit or Loss Statement. Calculation of profit or loss of a business is performed in two steps.

01. Calculation of gross profit
02. Calculation of net profit

01. Calculation of gross profit

The gross profit is calculated by deducting the cost of sales from the sales revenue.

Sales revenue

The total of cash sales and credit sales done during a particular accounting period is known as the sales revenue.

Example :-

	Rs.
Cash sales	58 000
Credit sales	76 000
Sales revenue	134 000

Cost of sales

Once the entire stock is sold out the cost of the inventories that was presented for trade is considered as the cost of sales. But a business organization can have some inventories yet to be sold at the end of an accounting period. In such situation the cost of sales is calculated by deducting the value of the closing stock from the cost of the goods that were presented for sales.

When preparing the financial statements the closing stock remaining at the end of the accounting period is considered as an asset and it becomes the opening stock of the next accounting period

Example :-

The same closing stock as at 31.12.2015, becomes the opening stock as at 01.01.2016 in the next accounting period.

There is no opening stock exists for a business in its first year of operation.

In a particular accounting period, a business has to purchase goods to sell as the opening stock of goods is not adequate for the sales to be done during the year. The purchases made in terms of cash and credit, totals for the purchases made during the accounting period.

Example :-

	Rs.
Cash purchases	24 000
Credit purchases	58 000
Total purchases	82 000

Transportation expenses, loading and unloading expenses, etc. has to be incurred when the purchased goods are transported to the business premises. In order to obtain the total cost of the inventories, all the expenses relating to purchases including the costs incurred in bringing stocks in to the current position and condition should be considered.

Example :-

	Rs.
Purchases	82 000
Loading expenses	6 000
Carriage inwards	9 000
Purchases and related expenses	97 000

Therefore, when calculating the cost of the goods sold, following elements are taken into consideration.

- Opening stock
- The total purchases including the cash and credit purchases
- Closing stock

Example :-

A business organization has following information.

	Rs.
Opening stock	15 000
Purchases	82 000
Loading expenses	6 000
Carriage inwards	9 000
Closing stock	22 000

The calculation of cost of sales using the above information is explained below.

	Rs.
Opening stock	15 000
Purchases	82 000
Loading expenses	6 000
Carriage inwards	9 000
Cost of goods to be sold	112 000
Less: closing stock	(22 000)
Cost of sales	90 000

Gross profit

The gross profit is derived by deducting the cost of sales from sales revenue.

Gross profit = Sales revenue - Cost of sales

The amount of total sales that exceed the total cost of sales is known as the gross profit.

Example :-

If the sales revenue is Rs. 134 000 and the cost of sales is Rs. 90 000, of a business organization, the gross profit is Rs. 44 000.

Sales revenue	- Cost of sales	=	Gross profit
134 000	- 90 000	=	44 000

If the sales revenue is less than the cost of sales, it will result in a gross loss.

Example :-

If the sales revenue is Rs. 134 000 and the cost of sales is Rs. 140 000 of a business organization, the gross loss is Rs. 6 000.

Sales revenue	- Cost of sales	=	Gross profit
134 000	- 140 000	=	(6 000)

Study how the gross profit or gross loss is calculated by using sales revenue and sales figures relating to cost of sales in the example given below.

The following information is given to you from the business of "Thisara" for the accounting period ended 31st December 20xx.

	Rs.
Purchases	75 000
Sales	168 000
Loading expenses	8 500
Carriage inward expenses	9 500
01.01.20xx opening stock	15 000
31.12.20xx closing stock	20 000

Calculation of gross profit for the year ended 31.12.20xx	Rs.	Rs.
Sales		168 000
Less: cost of sales		
Opening stock	15 000	
Purchases	75 000	
Carriage inward expenses	9 500	
Loading expenses	8 500	
Cost of goods to be sold	108 000	
Less: closing stock	(20 000)	
Cost of sales		(88 000)
Gross profit		80 000

Activity 01

Nisha stationery engages in a retail business of stationeries and the accounting period ends on 31st December 20xx. You are provided with the following information.

	Rs.		Rs.
Cash sales	80 000	01.01.20xx opening stock	15 000
Credit sales	120 000	31.12.20xx closing stock	18 000
Cash purchases	45 000	Loading expenses	6 000
Credit purchases	75 000	Carriage inward expenses	7 000

01. Calculate the following values for the year ended 31.12.20xx;
    - Cost of goods to be sold
    - Cost of sales
    - Gross profit

02. Indicate the above values in the form of a statement.

02. Calculation of net profit

When the gross profit or loss is calculated, the net profit or loss should also be calculated.

The details of the accounting elements, income and expenses that are used in preparing the profit or loss statement are given below.

Income

Increase in equity other than the introduction of capital by owners is known as income.

All other income earned not included in the gross profit is regarded as the other income. Some examples of other income include the followings.

Example :-

The interest income earned by depositing the excess cash.
The rent income earned by renting a section of the office building.
Dividend income earned through purchasing shares of public companies.
Discounts received, commission income received, etc.

In calculating the relevant net profit or loss of a business organization, all the above income should be considered.

Activity 02

The income and the cost of sales relating to a business for a given accounting period are given below;

	Rs.
Cash sales	70 000
Credit sales	48 000
Cost of sales	52 000
Dividend income	5 000
Rent income	30 000
Discount received	6 000
Interest income	7 000

Calculate ;

1. The gross profit or loss of the business.
2. The total of other income generated.

Expenses

The other important elements shown in the profit and loss account are the expenses. The decreases in equity other than the drawings of the owner are regarded as expenses. Insurance payments, rent payments, salaries to employees, depreciation of fixed assets, bad debts include as examples for expenses. These expenses are categorized as follows;

01. Distribution expenses
02. Administration expenses
03. Other expenses
04. Financial expenses

A brief explanation about the above categories of expenses are given below;

Distribution expenses

The expenses incurred for selling and distribution of a trading business is categorized as distribution expenses. This includes expenses incurred to sell the inventories, to promote the sales and carriage outwards.

Examples :-

Advertising expenses, salaries to sales employees, bad debts, discount given, depreciation of delivery vehicles, sales commission

Administration expenses

Expenses incurred for administration purposes of the business are categorized under administration expenses.

Examples :-

Rent payment, insurance payments, stationery expenses, depreciation for building, repair expenses, electricity expenses, depreciation for equipments

Other expenses

The expenses and losses that were not classified under above categories are categorized under other expenses.

Examples :-

Losses from cash frauds, losses from fire

Financial expenses

Expenses incurred in a business organization for borrowing of funds and in maintaining bank accounts are known as financial expenses.

Examples :-

Interest for bank loans, Interest for overdraft facilities, Bank charges

Activity 03

The following information is given from the Bhanuka's business for the accounting year ended on 31.12.20xx.

Bad debts	Depreciation of the distribution vehicle
Advertising expenses	Stationery expenses
Salaries for sales personnel	Insurance expenses
Interest expenses for bank loan	Bank charges
Electricity expenses	Rent payments
Discount allowed	Losses from cash frauds

Classify the above given expenses to the below given expense categories.

Distribution expenses	Administration expenses	Finance expenses	Other expenses

Study how the net profit is calculated using the example given below.

Examples :-

The following information is obtained from the business of Thimira for the accounting period ended on 31st December 20xx.

	Rs.		Rs.
Gross profit	230 000	Building repair expenses	45 000
Discount received	12 000	Expenses for sales promotions	30 000
Investment income	5 000	Salaries for sales personnel	24 000
Interest income	8 000	Interest for bank loan	12 000
Insurance expenses	16 000	Losses due to cash frauds	8 000
Salaries-administration	32 000		

Calculation of net profit for the year ended 31.12. 20xx

		Rs.	Rs.
Gross profit			230 000
Add: Other income			
Discount received		12 000	
Investment income		5 000	
Interest income		8 000	25 000
			255 000
Less : Expenses			
Distribution expenses			
Expenses for sales promotions	30 000		
Salaries for sales personnel	24 000	54 000	
Administration expenses			
Insurance expenses	16 000		
Salaries - administration	32 000		
Building repair expenses	45 000	93 000	
Other expenses			
Losses due to cash frauds	8 000	8 000	
Finance expenses			
Interest for bank loan	12 000	12 000	(167 000)
Net profit transferred to the capital account			88 000

Preparation of Profit or Loss Statement

You have already studied that the profit or loss statement should be prepared to show the operational results of a business.

Let's study to calculate and present the gross profit and the net profit by preparing the profit or loss statement which was studied in two steps above.

The information presented in profit or loss statement can be presented using a format below.

Business of................

Profit or Loss Statement

For the year ended 31st Dec. 20xx.

	Rs.	Rs.	Rs.
Sales			xxxx
Less: cost of sales			
Opening stock		xx	
Purchases		xx	
Loading expenses		x	
Carriage inward expenses		x	
Cost of goods to be sold		xxx	
Less: closing stock		(xx)	
Cost of sales			(xxx)
Gross Profit			xxx
Add: other income			
Rent income		xx	
Interest income		xx	
Discount received		xx	xx
			xxxx
Less: Expenses			
Distribution expenses			
Advertising expenses	xx		
Salaries for sales personnel	xx		
Discount given	xx		
Bad debts	xx		
Depreciation for distribution vehicle	xx	xx	
Administration expenses			
Electricity expenses	xx		
Insurance charges	xx		
Salaries - administration	xx		
Telephone expenses	xx		
Depreciation for machinery	xx	xx	
Other expenses			
Losses from cash frauds	xx		
Stocks written off	xx	xx	
Finance expenses			
Interest on bank loan	xx		
Interest on bank over draft	xx		
Bank charges	xx	xx	(xxx)
Net profit transferred to the capital account			xx

The example given below explains how to prepare the income statement using the data given in a trial balance.

Example :-

The trial balance of the Naveesha's business is given below

Account name	Dr. Rs.	Cr. Rs.
Stock as at 01.01.20xx.	8 000	
Purchases	145 000	
Carriage inward expenses	6 000	
Loading expenses	3 000	
Sales		456 000
10% Fixed deposit	40 000	
Interest income on fixed deposit		4 000
Machine and equipment	140 000	
Discount received		7 000
Discount given	6 000	
Insurance charges	8 000	
Stationery expenses	5 000	
Sales promotional expenses	20 000	
Salaries to sales personnel	36 000	
Rent expenses	30 000	
Trade debtors	50 000	
Bad debts	2 000	
Cash balance	61 000	
Bank overdraft		20 000
Bank loan at 10%		60 000
Interest on 10% bank loan	6 000	
Interest on bank over draft	1 000	
Capital		20 000
	567 000	567 000

Note: All goods purchased for resale have been sold.

Business of Naveesha
Profit or Loss Statement
For the year ended 31. 12.20xx

	Rs.	Rs.	Rs.
Sales			456 000
Less: Cost of sales			
Opening stock		8 000	
Purchases		145 000	
Loading expenses		3 000	
Carriage inward expenses		6 000	
Cost of sales			(162 000)
Gross profit			294 000
Add: Other income			
Interest income on fixed deposit		4 000	
Discount received		7 000	11 000
			305 000
Less: Expenses			
Distribution expenses			
Sales promotional expenses	20 000		
Salaries for sales personnel	36 000		
Discount given	6 000		
Bad debts	2 000	64 000	
Administration expenses			
Insurance charges	8 000		
Stationary expenses	5 000		
Rent expenses	30 000	43 000	
Finance expenses			
Interest on bank loan	6 000		
Interest on bank over draft	1 000	7 000	(114 000)
Net profit transferred to the capital account			191 000

For your extra reference



There are two forms of presenting the operating results of a business. One way is to present it in the form of a statement that you have already studied above. It is how the operating result is presented according to the current practice.

However, in the past that information were presented in a format of an account.

Though that method is used at times, *only for your extra reference,* it is presented below in a format of an account by using the details of the example given above.

Business of Naveesha
Trading and Profit and Loss Account
for the year ended 31. 12.20xx

	Rs.	Rs.		Rs.
Opening stock 01.01.20xx		8 000	Sales	456 000
Purchases	145 000			
Loading expenses	3 000			
Carriage inward expenses	6 000	154 000		
Cost of sales		162 000		
Gross profit c/d		294 000		
		456 000		456 000
Distribution expenses			Gross profit b/f	294 000
Sales promotion expenses	20 000		Interest income	4 000
Salaries for sales personnel	36 000		Discount received	7 000
Discount given	6 000			
Bad debts	2 000	64 000		
Administration expenses				
Insurance charges	8 000			
Stationary expenses	5 000			
Rent expenses	30 000	43 000		
Finance expenses				
Interest on bank loan	6 000			
Interest on bank over draft	1 000	7 000		
		114 000		
Net profit transferred to the capital a/c		191 000		
		305 000		305 000

Activity 04

Following figures has been extracted from the business of Malee for the year ended 31.12.20xx.

Capital	300 000	Discount given	5 000
Sales	650 000	Bad debts	9 000
Discount received	12 000	Administrative salaries	40 000
Bank loan	80 000	Sales promotional expenses	60 000
Stock as at 01.01.20xx	15 000	Interest expense on bank loan	6 000
Commission income	6 000	Bank charges	2 000
Purchases	200 000	Trade debtors	45 000
Carriage inward expenses	5 000	Buildings	280 000
10% Fixed deposit	60 000	Stationery expenses	8 000
Insurance expense	12 000	Cash balance	301 000
Fixed deposit income	6 000	Losses from cash frauds	2 000

All the goods purchased have been sold

01. Calculate the following separately

1. Cost of sales
2. Gross profit
3. Other income
4. Distribution expenses
5. Administration expenses
6. Other expenses
7. Financial expenses
8. Net profit

02. Prepare the Profit or Loss Statement for the year ended 31.12.20xx.

4.4 Statement of Financial Position

After preparing the income statement, the trail balance is only left with the balances of the accounts of Assets Liabilities and Equity. The statement that is prepared to include the balances of assets, liabilities and equity is called the Statement of Financial Position. This is also was called as the Balance Sheet in the past. This shows the business organization's financial strength and ability.

The information given in the Statement of Financial Position will be helpful for the economic decision making of the stakeholders of the organization like owners, creditors, and financial institutions.

The elements of the financial position

As at a particular date, the assets liabilities and equity a company posses can also be expressed by the accounting equation which has been already discussed. The accounting equation can be depicted as follows;

Assets = Equity + Liabilities

The values summarized for the assets, liabilities and equity are shown in the Statement of Financial Position on a rational basis.

The statement of financial position includes three main elements

- Assets
- Equity
- Liabilities

Assets

An asset is a resource controlled by the business as a result of a past transaction and from which future economic benefits are expected to flow to the business.

In grade 10 study text you have already discussed about the assets that a business owns and the fact that they can be divided in to two as non-current assets and current assets. Go through the example given below to see the categorization of assets in the Statement of Financial Position.

Example :-

The accounting period for Nadeeka's business is from 01.01.20xx to 31.12.20xx. As at 31.12.20xx the following assets existed.

Closing stock 31.12.20xx	Rs. 30 000	Machinery	Rs. 60 000
Land and buildings	Rs. 280 000	Delivery motor vehicle	Rs. 400 000
Furniture	Rs. 20 000	Cash in hand	Rs. 80 000
Trade debtors	Rs. 45 000	Fixed deposit (5 years)	Rs. 50 000
Cash at bank	Rs. 15 000	Fixed deposit (6 months)	Rs. 20 000

Business of Nadeeka
Statement of Financial Position as at 31st December 20xx (extracts)

	Rs.	Rs.
Non-current assets		
Land and buildings	280 000	
Furniture	20 000	
Machinery	60 000	
Motor vehicles	400 000	
	760 000	
Fixed deposit (5 Years)	50 000	810 000
Current assets		
Closing stock	30 000	
Trade debtors	45 000	
Fixed deposits (6 months)	20 000	
Cash at bank	15 000	
Cash in hand	80 000	190 000
Total assets		1 000 000

The assets of a business are presented in the order of liquidity in a statement of financial statement. The ability convert an asset to cash with minimum losses in a short period of time is defined as the liquidity. The assets with the less liquidity are shown first.

Examples :-

The stocks are regarded as having less liquidity, and it is shown first under the current assets while the most liquid asset, cash in hand (which is regarded as having 100% liquidity) is presented last. Same is followed in presenting the non-current assets as well.

Activity 05

The accounting period of the Sunimal's business starts on 1st January 20xx and ended on 31st December 20xx. As at 31.12 20xx the following balances are extracted.

	Rs.
Machinery and equipments	185 000
Furniture	25 000
Closing stock (31.12.20xx)	65 000
Trade debtors	52 000
Cash in hand	65 000
Motor vehicles	340 000
Cash at bank	40 000
Income receivable	16 000

Show the categorization of assets as current and non-current in an extract of a Statement of Financial Position.

Equity

Once organizations use its assets to settle its external liabilities, the residual is called as Equity which belongs to the owners of the business. The part of asset that belongs to owners of the business is termed as equity. Equity is increased as a result of net profit and new capital introduction it is decreased as a result of net losses and drawings. In a sole proprietorship, capital account presents the total equity belonging to the owner.

Go through the example given below to understand how the equity is calculated.

Examples :-

The accounting period starts on 01.01.20xx and ends on 31.12.20xx.

Capital as at 01.01.20xx	150 000
Withdrawals – cash	12 000
Withdrawals – goods	8 000
Net profit for the period	50 000

Calculation of equity as at 31.12.20xx

	Rs.	Rs.
Capital as at 01.01.20xx	150 000	
Add: Net Profit	50 000	
	200 000	
Less: Withdrawals	(20 000)	180 000
Equity as at 31.12.20xx		180 000

Capital of Rs. 180 000 as at 31.12.20xx is the equity of the owner.

Activity 06

On 01.01.20XX, Sudheera started a retail business of kids wear by investing Rs. 240 000 in cash. Further he has invested Rs. 30 000 worth of furniture and Rs. 300 000 worth of his own building for the business.

The business earned Rs. 360 000 worth of income and incurred expenses of Rs. 210 000 for the 06 months ended 30.06.20XX. During this period Sudheera has withdrawn Rs. 18 000 in cash and Rs. 7 000 worth of kids wear from the business.

You are required to calculate the following.

01. Capital as at 01.01.20XX.
02. Profit earned during the period
03. Total withdrawals made within the period
04. Equity of Sudheera as at 30.06.20XX.

Liabilities

Obligations of a business that had arose as a result of past transactions or events could be simply considered as liabilities.

In grade 10 study text you have already discussed about the liabilities and the fact that they can be divided in to two as non-current liabilities and current liabilities.

Go through the example given below to see the categorization of current and non-current liabilities according to the liquidity basis in the Statement of Financial Position.

Examples :-

The liabilities of a business as at 31.12.20xx are given below.

	Rs.
Trade creditors	25 000
Rent payable	8 000
Bank loan payable in three years	50 000
Insurance expenses payable	4 000
Loan interest payable	6 000
Mortgage loan payable in two years	30 000

The schedule of liabilities as at 31.12.20xx (extract)

	Rs.	Rs.
Non-current liabilities		
Bank loan	50 000	
Mortgage loan	30 000	80 000
Current liabilities		
Trade creditors	25 000	
Rent payable	8 000	
Insurance expense payable	4 000	
Interest payable	6 000	43 000

Activity 07

Madushan has obtained a bank loan for Rs. 480 000 which is payable annually in 5 years. Further, this business has trade creditors for Rs. 60 000, accrued employee salaries is Rs. 9 000 and accrued telephone expenses of Rs. 4 000.

Show the categorization of liabilities as current and non-current in an extract of a Statement of Financial Position.

Accordingly, to present rationally the assets, liabilities and equity that an organization holds as at a particular date in a Statement of Financial Position following format can be used.

Business of ....

Statement of Financial Position

As at...........................

Non-current assets		
Land & buildings	xxx	
Motor vehicles	xxx	
Furniture & fittings	xxx	
Machinery	xx	xxx
Long term fixed deposit		xx
Current assets		
Closing stock	xx	
Trade debtors	xx	
Income receivable	xx	
Bank	xx	
Cash in hand	xx	xx
Total assets		xxxx
Equity & liabilities		
Capital as at 01.01.20xx	xx	
Add-net profit	xx	
	xxx	
Less-Drawings	(x)	xx
Non-current liabilities		
Bank loan		xx
Current Liabilities		
Trade creditors	xx	
Accrued expenses	xx	
Bank overdraft	xx	xx
Equity and liabilities		xxxx

Examples :-

The accounting period of Maneesha's business starts on 01.01.20xx and ends on 31.12.20xx. Following information given as at 31.12.20xx.

	Rs.		Rs.
Land and buildings	280 000	Cash in hand	90 000
Trade debtors	60 000	Drawings	12 000
Trade creditors	73 000	Closing stocks	55 000
Furniture	30 000	Delivery vehicle	550 000
Fixed deposit (5 years)	120 000	Capital as at 01.01.20xx	600 000
Income receivable	16 000	Profit for the period	325 000
Accrued expenses	15 000	Bank loan (To be paid at the end of 3 years)	200 000

The statement of financial position prepared is given below.

Business of Maneesha
Statement of Financial Position
as at 31.12.20xx

	Rs.	Rs.
Non current assets		
Land & building	280 000	
Furniture	30 000	
Delivery vehicle	550 000	860 000
Fixed deposit (5 years)		120 000
Current assets		
Closing stock	55 000	
Trade debtors	60 000	
Income receivable	16 000	
Cash in hand	90 000	221 000
Total assets		1 201 000
Equity and liabilities		
Capital as at 01.01.20xx	600 000	
Add : net profit	325 000	
	925 000	
Less : drawings	(12 000)	913 000
Non current liabilities		
Bank loan		200 000
Current liabilities		
Trade creditors	73 000	
Accrued expenses	15 000	88 000
Total equity and liabilities		1 201 000

For your extra reference

Another method which was used to present assets, liabilities and equity in the past is given below *for only your extra reference* by using the details of the example given above.

Business of Maneesha
Balance Sheet as at 31.12.20xx

					Cost Rs.
Capital as at 01.01.20xx	600 000		Non-current assets		
Add : net profit	325 000		Land & buildings		280 000
	925 000		Delivery vehicle		550 000
Less : drawings	12 000	913 000	Furniture		30 000
					860 000
Non-current liabilities			Fixed deposit (5 years)		120 000
Bank loan		200 000			
			Current assets		
Current liabilities			Closing stock	55 000	
Trade creditors	73 000		Trade debtors	60 000	
Accrued expenses	15 000	88 000	Income receivable	16 000	
			Cash in hand	90 000	221 000
		1 201 000			1 201 000

Activity 08

According to the accounting equation, shown below is the financial position of Sumudu's business as at 31.12.20xx.

Building + Machinery+ Furniture+ Inventory+ Debtors+ Cash = Capital + Bank loan + Creditors

240 000 + 60 000 + 20 000 + 30 000 + 50 000 + 80 000 = 300 000 + 100 00 + 80 000

Show the above information in a Statement of Financial Position.

Activity 09

The accounting period of Sarani's business starts on 01.01.20xx and ends on 31.12.20xx. Information given below are provided to you.

	Rs.		Rs.
Capital as at 01.01.20xx	320 000	Cash	24 000
Land and building	340 000	Machinery	40 000
Furniture	92 000	Net profit for the year	140 000
Stocks as at 31.12.20xx	56 000	Bank loan (5 Years)	80 000
Trade debtors	48 000	Trade creditors	80 000
Drawings	15 000	Bank overdraft	35 000
Investment (2 Years)	60 000	Accrued expenses	20 000

01. Write down the relevant items in the 1-5 tables by using the given format below.

1.

Non-current assets	Rs.	Total Rs.

2.

Current assets	Rs.	Total Rs.

3.

Equity	Rs.	Total Rs.

4.

Non-current liabilities	Rs.	Total Rs.

5.

Current liabilities	Rs.	Total Rs.

02. Prepare the Statement of Financial Position as at 31.12.20xx

Activity 10

The accounting period of Bimali's business ends on 31.12.20xx. The trial balance as at 31.12.20xx is given below.

Account name	Debit Rs.	Credit Rs.
Capital		400 000
Trade debtors	34 000	
Trade creditors		45 000
Stocks as at 01.01.20xx	16 000	
Purchases	395 000	
Carriage inwards	15 000	
Sales commission	9 000	
Insurance expenses	12 000	
Rent income		30 000
Discount received		6 000
Sales		650 000
Discount given	3 000	
Machinery and equipment	120 000	
Buildings	500 000	
Bank loan (to be settled after 4 years)		160 000
Interest expenses	16 000	
Bank overdraft		20 000
Cash in hand	155 000	
Bad debts	7 000	
Salaries - administration	25 000	
Bank charges	4 000	
	1 311 000	1 311 000

Assume that the entire stock has been sold out.

Prepare;

01. The profit or loss statement for the year ended 31st December 20xx
02. The Statement of Financial Position as at 31st December 20xx

Chapter 05

Financial Statements Including the Adjustments

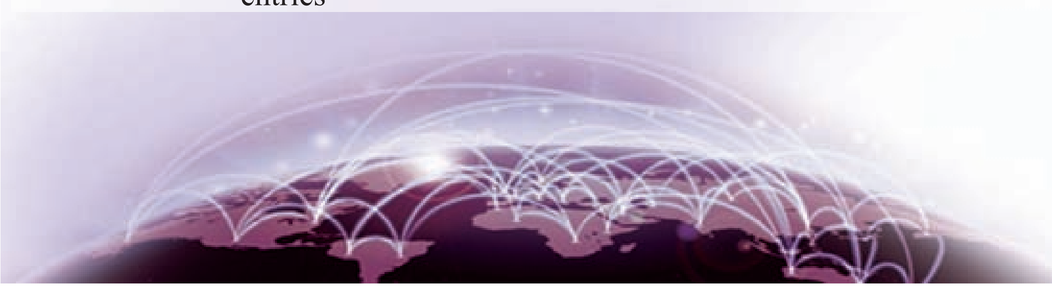
This chapter discusses the followings.

5.1 Introduction to adjusting entries

5.2 Recording of adjusting entries
- ☆ Accrued expenses
- ☆ Accrued income
- ☆ Bad debts
- ☆ Depreciation

5.3 Presentation of non-current assets in the Statement of Financial Position

5.4 Presentation of financial statements incorporating the adjusting entries



5.1 Introduction to adjustment entries

The recording of business transactions using the double entry system and preparation of the trial balance after balancing the ledger accounts are discussed previously. Even though every business transaction has to be recorded in the books of accounts some transactions may not have been adjusted in the accounting period. In addition some balances in the ledger accounts can only be taken to the trail balance after making the necessary adjustments.

Adjustment entries that are required to present the financial statements with the most relevant and accurate figures are called adjusting entries.

The adjustment entries are used to adjust the values of assets, liabilities, income and expense accounts according to the accounting period. In calculating the operational performance of the organization, expenses and income irrespective of they had been received in cash or not, the relevent amounts should be considered as relevant for the period. This is done according to the accrual concept.

In addition as per the accrual concept, irrespective of the amount received in cash the total income relevant for the period should be recorded as well as irrespective of the amount paid in cash, the total expense relevant for the period should be recorded.

General journal is used to record the adjustment entries to the books of account.

The importance of adjusting entries in preparing financial statements can be summarized as follows;

- ☆ The balances in the ledger accounts can be updated as at the end of the accounting period
- ☆ The operational result i.e., profit or loss of the period can be calculated accurately
- ☆ The assets, liabilities, and equity of the business as at the end of the period or the financial position at the end of the period can be accurately disclosed.
- ☆ The financial statements can be prepared according to the accepted policies and standards
- ☆ The stakeholders of the business can use accurate information to make accurate economic decisions.

5.2 Recording of adjustment entries

This chapter discusses only about the Preparation of Financial Statements of a sole proprietor and includes adjustments most relevant for that type of entity.

- ☆ Accrued expenses
- ☆ Income receivable
- ☆ Bad debts
- ☆ Depreciation



Figure 5.1

Accrued expenses

Accrued expenses are the expenses that an organization has incurred for obtaining the goods and services for a specific accounting period, but the payment for which is still outstanding. This is also called expenses payable. The value of accrued expense is a liability of the business.

Given below is the journal entry relevant for recording the accrued expenses

Relevant expense account	Dr.
Accrued expense account	Cr.

In the double entry system, an increase in expenses are debited while an increase in liabilities are credited. Therefore, the relevant accrued expense is debited to the expense account and increase of liability, the amount of accrued expense is credited to the liability account.

Examples :-

The accounting period of the Tharindu's business is from 01.01.20xx to 31.12.20xx the following information relates to the accrued expenses.

01. Annual insurance expense is Rs. 6 000 and the company has only paid Rs. 4 000 in cash.

02. Monthly rent of the business building is Rs. 8 000 and has been only paid for 10 months.

03. A bank loan has been obtained for Rs. 50 000 on 01.01.20xx at an interest rate of 12%. Bank interest for two months has not been paid.

As per the example, the accrued expenses as at 31.12.20xx are as follows;

1. Accrued insurance expense (Rs. 6 000 - Rs. 4 000) = Rs. 2 000
2. Accrued rent (Rs. 8 000 x 2) = Rs. 16 000
3. Accrued bank interest (Rs. 50 000 x $\frac{12}{100}$ x $\frac{2}{12}$) = Rs. 1 000

The journal entries relating to the above example are as follows:

General Journal

Date	Journal V.N.	Description	Dr. Rs.	Cr. Rs.
31.12.20xx	001	Insurance account Dr. Accrued insurance expense a/c (Accounting for accrued insurance expense)	2 000	 2 000
31.12.20xx	002	Rent account Dr. Accrued rent a/c (Accounting for the accrued rent)	16 000	 16 000
31.12.20xx	003	Bank interest account Dr. Accrued bank interest a/c (Accounting for interest for the bank loan)	1 000	 1 000

The accrued expense of the Tarindu's business is accounted in the books of accounts as follows;

Dr. Insurance expense account Cr.

Date	Description	L. F.	Value Rs.	Date	Description	L. F.	Value Rs.
.........20xx	Cash		4 000				
31.12.20xx	Accrued insurance exp.		2 000				

Dr. Accrued insurance expense account Cr.

Date	Description	L. F.	Value Rs.	Date	Description	L. F.	Value Rs.
				31.12.20xx	Insurance expense		2 000

Dr. Rent account Cr.

Date	Description	L. F.	Value Rs.	Date	Description	L. F.	Value Rs.
..........20xx 31.12.20xx	Cash Accrued rent		80 000 16 000				

Dr. Accrued rent account Cr.

Date	Description	L. F.	Value Rs.	Date	Description	L. F.	Value Rs.
				31.12.20xx	Rent		16 000

Dr. Interest expense of the bank loan A/C Cr.

Date	Description	L. F.	Value Rs.	Date	Description	L. F.	Value Rs.
..........20xx 31.12.20xx	Cash Accrued interest		5 000 1 000				

Dr. Accrued bank interest account Cr.

Date	Description	L. F.	Value Rs.	Date	Description	L. F.	Value Rs.
				31.12.20xx	Bank interest		1 000

When the accrued expenses are adjusted to the relevant expense accounts, the expenses relevant for the period is obtained. This should be shown in the Profit or Loss Statement. How those expenses are relevant for the period (including the accrued expenses) are included in the Profit or Loss Statement and how the accrued expenses are shown in the Statement of Financial Position under the current liabilities are depicted below;

Profit or Loss Statement (extracts)

	Rs.
Insurance expenses	6 000
Rent	96 000
Bank loan interest	6 000

Statement of Financial Position (extracts)

	Rs.
Current liabilities	
Accrued insurance	2 000
Accrued rent	16 000
Accrued bank interest	1 000

Activity 01

The accounting period of Nayani's business ends on 31.12.20xx. The transactions done in the business are given below

1. Monthly rent for the shop is Rs. 5 000 and only 08 months rent has been paid.
2. Rs. 18 000 has been paid as the electricity expenses; electricity expense of Rs. 3 000 relevant for the month of December has not been paid.
3. Bank loan has been obtained for Rs. 80 000 on 01.12.20xx at an interest of 12%. The interest for the month of December has not been paid.
4. Accrued telephone expense as at 31.12.20xx is Rs. 3 000.
5. Carriage expense of Rs.2 000 is to be paid.
6. The annual stationery expense is Rs. 19 000, but only Rs. 5 000 has been paid

01. Calculate the correct value for the expense account and note in the given chart

Expense account	Amount paid in cash	Accrued expense	Expense relevant for the period after adjustments
1.			
2.			
3.			
4.			
5.			
6.			

02. Write the correct double entries for the adjustments required.

Transaction	Account to debit with the value	Account to credit with the value
1.		
2.		
3.		
4.		
5.		
6.		

03. Indicate the of journal entries for the adjustments and record transactions in the ledger.

04. Show the extracts of the financial statements.

Profit or Loss Statement (extracts) Rs.

Statement of Financial Position (extracts) Rs.

Income receivable

Income receivable are the income receivable within the accounting period but has not been received yet at the end of the accounting period. These are also known as the accrued income.

The amount receivable is regarded as an asset and income receivable must be adjusted in presenting the accurate operational results and the financial position. The accrued income can be adjusted using the general journal.

The journal entry to record the accrued expenses are as follows;

Income receivable account	Dr.
Relevant income account	Cr.

Income receivable is an income relevant for the accounting period. The relevant income account is credited and the income receivable account is debited as per the double entry rule.

Example :-

The accounting period of Parami's business ends on 31.12.20xx.

1. Rent income of Rs. 12 000 has been received and rent income of Rs. 3 000 is yet to be received.

2. A fixed deposit of Rs. 120 000 at an interest of 10% has been opened on 01.04.20xx and the interest income has been accrued for the month of December.

As per the example, the accrued income of Parami's business as at 31.12.20xx is as follows;

01. Rent income receivable Rs. 3 000
02. Interest income receivable Rs. 1 000

Accordingly, the journal entries relating to the example is as follows;

General Journal

Date	Journal V.No.	Description	L.P.	Dr. Rs.	Cr. Rs.
31.12.20xx	001	Rent income receivable Dr.		3 000	
		Rent income a/c			3 000
		(Accounting for rent income receivable)			
31.12.20xx	002	Interest income receivable Dr.			
		Interest income		1 000	
		(Accounting for interest income receivable)			1 000

Recording of accrual income in to the ledger accounts are shown below

Dr. Rent income account Cr.

Date	Description	L. F.	Value Rs.	Date	Description	L. F.	Value Rs.
				..........20xx	Cash		12 000
				31.12.20xx	Rent income receivable		3 000

Dr. Rent income receivable account Cr.

Date	Description	L. F.	Value Rs.	Date	Description	L. F.	Value Rs.
31.12.20xx	Rent income		3 000				

Dr. Interest income account Cr.

Date	Description	L. F.	Value Rs.	Date	Description	L. F.	Value Rs.
				..........20xx	Cash		8 000
				31.12.20xx	Interest income rec.		1 000

Dr. Interest income receivable account Cr.

Date	Description	L. F.	Value Rs.	Date	Description	L. F.	Value Rs.
31.12.20xx	Interest income		1 000				

Once the receivable incomes are adjusted to relevant income accounts, the income relevant to the accounting period can be obtained. These need to be included in the Profit or Loss Statement.

- ☆ The rent income of Rs.15 000 relevant for the accounting period should be shown in the Profit or Loss Statement and the rent income receivable of Rs. 3 000 should be recorded in the Statement of Financial Position under the current assets.
- ☆ Rs. 9 000 of interest income relevant for the accounting period should be recorded in the Profit or Loss Statement and the accrued interest income should be listed under the current assets in the Statement of Financial Position.

Extracts of the Financial Statements

Profit or Loss Statement (extracts) Rs.

Rent income	15 000
Interest income	9 000

Statement of Financial Position (extracts) Rs.

Current assets	
Accrued rent income	3 000
Accrued interest income	1 000



Activity 02

The financial year of Dilahara Enterprise ends on 31.12.20xx

1. A shop has been rented for Rs. 6 000 per month from 01.01.20xx. Rent income relevant to only 08 months has been received in cash.
2. Money of the business has been deposited to open a fixed deposit for Rs. 50 000 on 01.05.20xx. Interest income of Rs. 4 000 has been received while Rs. 2 000 is to be received relevant to this fixed deposit.
3. Only Rs. 6 000 has been received out of the Rs. 8 000 of dividend income receivable.
4. Sales commission income of Rs. 4 000 is to be received as a result of selling goods owned by another enterprise.

Required;

01. Calculate the proper values and record them in the relevant columns.

Transaction	Income received in cash Rs.	Accrued income Rs.	Income relevant to the accounting period Rs.
1. 2. 3. 4.			

02. Write the correct journal entries including the value for the adjustment to be done.

Transaction	Account to debit Rs.	Account to credit Rs.
1. 2. 3. 4.		

03. Prepare and record the adjustments in the general journal and post them to the ledger accounts.

04. Show the extracts of the financial statements using the tables below

Profit or Loss Statement (extracts) Rs.

Statement of Financial Position (extracts) Rs.

Bad debts

When a business sells goods on credit, the amount of credit receivable is called trade debtors or trade receivables. The business sometimes may not be able to recover the credit receivable due to debtors being bankrupt or diseased.



When an organization cannot recover the money from trade debtors due to any reason, such unrecoverable amount is called "Bad debts".

As a result of bad debts, the asset of trade debtors is reduced and that is recognized as a loss to the business. This loss is recognized as an expense to the business and it is included in the Profit or Loss Statement.

Therefore, the unrecoverable amount from debtors should be deducted from the debtors account by crediting the account and should be debited to the bad debts account as an expense. The journal entry for the bad debts is given below

Bad debts account	Dr.
Trade debtors account	Cr.

Example :-

Kithsiri's Business has sold goods on credit to Sameera for Rs. 8 500 on 01.08.20xx As Sameera has died in an accident, it is decided to write off the dues from him as at 31.12.20xx.

The journal entries and ledger accounts are shown below

General Journal

Date	Journal V.No.	Description	L.P.	Dr. Rs.	Cr. Rs.
31.12.20xx		Bad debts account Dr.		8 500	
		Sameera's a/c (trade debtors)			8 500
		(Amount receivable from Sameera being written off as bad debts)			

Dr. Bad debts a/c Cr.

Date	Description	L. F.	Value Rs.	Date	Description	L. F.	Value Rs.
31.12.20xx	Sammera's a/c		8 500				

Dr. Sameera's a/c Cr.

Date	Description	L. F.	Value Rs.	Date	Description	L. F.	Value Rs.
01.08.20xx	Sales		8 500	31.12.20xx	Bad debts a/c		8 500

Depreciation

In order to present the financial position and the performance in a better manner of a business organization, some assets of the business should be depreciated. These are the assets that are not intended to resale, but used in the operations of the business and have a long term existence. These assets such as buildings machinery, office equipment and motor vehicles are called non-current assets. The amount of asset depletion during its economic useful life or due to asset being outdated is known as depreciation. Factors for depreciation includes economic factors such as being out of date and physical factors such as wear and tear.

The total cost of the asset comprises of all the costs incurred for bringing the asset into the present location and usable condition. Such assets can be used for more than one year. These assets may be sold to another party at the end of the life of the asset and the amount obtained is known as scrap value.

Accordingly, there is an opportunity to recover a part of the cost of an asset through the scrap value. But the scrap value will not represent a significant portion of cost of an asset and therefore a major portion of an asset cost is not recoverable. This irrecoverable cost of the asset should be regarded as an expense over the years that the asset is expected to use.

Example :-

A machine has been obtained for a cost of Rs. 500 000 and it is expected to be used for 5 years. If the scrap value of the machine is Rs. 100 000, the irrecoverable portion of the cost of the asset is Rs. 400 000. Since the expected useful life of the machine is 5 years, this Rs. 400 000 should be expensed over the 5 years as an expense. Therefore this expense should be distributed between the said 05 years.

Accordingly, when an asset has a scrap value, the balance we get by deducting the scrap value from the cost should be distributed between its estimated economic life as an expense.

According to the example above, Rs. 400 000 which we get, once the scrap value of Rs. 100 000 is deducted from the cost of Rs. 500 000, should be distributed within the 5 years of economic useful life as an expense.

There are a number of factors that contribute in deciding the amount of depreciation per annum of an asset

01. Cost of the asset
02. Estimated use of life of the asset
03. Scrap value of the asset

The costs of asset includes the purchase cost of an asset and the costs incurred in bringing the asset to the present location and usable condition.

Example :-

A business has purchased a machine for its production and the costs incurred relevant to the machine is given below

	Rs.
Purchase cost of the machine	200 000
Carriage inward cost	20 000
Installation cost	30 000
Total cost of the machine	250 000

The economic useful life of the asset is the time period which the asset is expected to be used or the number of units expected to be produced.

Example :-

If a machine costing Rs. 250 000 is expected to be used for 10 years productively in the business, the economic useful life of the asset is considered as 10 years.

As explained earlier, the scrap value is the net value expected to obtain by selling the asset at the end of its useful life.

Example :-

If an asset costing Rs. 250 000 can be sold for Rs. 30 000 at the end of its 10 year useful life, Rs. 30 000 is the scrap value of the asset.

The value obtained after deducting the scrap value of the asset from the cost of the asset is known as depreciable value of the asset. If the scrap value is not material (if not significant), the total cost of the asset can be considered as the depreciable value of the asset ignoring the scrap value of the asset.

Accordingly, the annual depreciation value of the asset can be calculated by considering the factors, cost of the asset, estimated useful life, and scrap value, after selecting a method to depreciate. There are several methods that can be used to depreciate assets. But here, only Straight-line depreciation method is discussed.

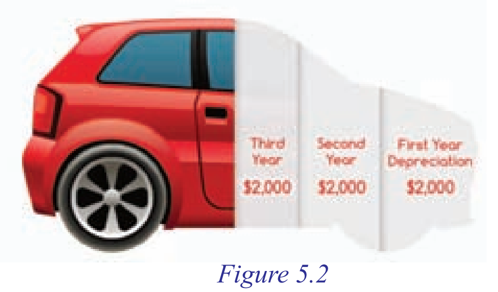


Figure 5.2

Using the straight line depreciation method, the depreciable value of an asset is depreciated annually over its useful life equally.

Therefore, the annual depreciation charged is equal over the depreciable years and following equation can be used to calculate the annual depreciation.

$$\text{Annual Depreciation} = \frac{\text{Cost} - \text{Scrap value}}{\text{Estimated useful life}}$$

Example :-

A business has purchased a machine to be used in its production and the following are the information relevant to the machine purchased.

	Rs.
Cost of the machine	820 000
Installation cost	30 000
Scrap value	50 000
Estimated useful life (in years)	10

Annual depreciation;

$$= \frac{850\,000 - 50\,000}{10 \text{ years}} = \frac{800\,000}{10}$$

$$= \underline{\underline{\text{Rs. } 80\,000}}$$

Instead of estimated useful life, a percentage can also be used. As per the above example, as the estimated useful life is 10 years, the depreciation should be done over 10 years. Accordingly, annual depreciation is 1/10th of the depreciable value. 1/10th is equal to 10%. If the depreciation done for 5 years, then the annual depreciation is 1/5th of the depreciable value and 1/5th is equal to 20%.

When using a percentage, to calculate depreciation;

$$\text{Annual depreciation} = (\text{Cost} - \text{Scrap value}) \times \text{Percentage of depreciation}$$

Activity 03

A business has purchased a motor vehicle for administration purpose and following information relates to the motor vehicle purchased;

Purchase cost of the motor vehicle	Rs. 800 000
Carriage inward cost from the showroom	Rs. 20 000
Scrap value	Rs. 70 000
Estimated useful life (in years)	5

Calculate the followings;

1. Cost of the motor vehicle
2. Depreciable value of the motor vehicle
3. If the straight line method is used for depreciation, annual amount of depreciation

Accounting for depreciation

The annual depreciation is considered as an expense relevant for the accounting period and debited to the depreciation expense account. A separate account should be opened in the name of "Accumulated depreciation" to record the credit entry. This is because to keep the depreciation portion that is deducted from the annual profits until the relevant asset is disposed.

The double entry relevant for the depreciation relating to an accounting period is as follows;

Relevant depreciation account	Dr.
Accumulated depreciation account	Cr.

Example :-

The accounting period of Wathsala's Business ends on 31.12.20xx. the non-current assets of the business are depreciated using the straight line method annually at 10% and the business maintains an accumulated depreciation account.

The non-current assets which were purchased on 01.01.20xx are given below;

Motor vehicles (at cost)	Rs. 800 000
Machinery and Equipments	Rs. 250 000

Observe how the annual depreciation is being recorded in a general journal and posted in to the ledger accounts.

General Journal

Date	Journal V. No	Description	L. F.	Dr. Rs.	Cr. Rs.
31.12.20xx	001	Motor vehicle depreciation account Dr. Accumulated motor vehicles depreciation a/c (Recording of annual motor vehicle depreciation in the books of accounts)		80 000	80 000
31.12.20xx	002	Machinery depreciation account Dr. Accumulated machinery depreciation a/c (Recording of annual machinery depreciation to the books of accounts)		25 000	25 000

Dr. Motor vehicle account Cr.

Date	Description	L. F.	Value Rs.	Date	Description	L. F.	Value Rs.
01.01.20xx	Cash		800 000				

Dr. Motor vehicle depreciation account Cr.

Date	Description	L. F.	Value Rs.	Date	Description	L. F.	Value Rs.
31.12.20xx	Acc.dep. a/c. of motor vehicle		80 000				

Dr. Accumulated motor vehicle depreciation account Cr.

Date	Description	L. F.	Value Rs.	Date	Description	L. F.	Value Rs.
				31.12.20xx	Motor vehicle depreciation a/c		80 000

Dr. Machinery account Cr.

Date	Description	L. F.	Value Rs.	Date	Description	L. F.	Value Rs.
01.01.20xx	Cash		250 000				

Dr. Depreciation account - machinery Cr.

Date	Description	L. F.	Value Rs.	Date	Description	L. F.	Value Rs.
31.12.20xx	Accumulated depreciation a/c		25 000				

Dr. Accumulated machinery depreciation account Cr.

Date	Description	L. F.	Value Rs.	Date	Description	L. F.	Value Rs.
				31.12.20xx	Machinery depreciation a/c		25 000

The balances in the depreciation accounts should be recognized as expenses relevant for the period. The accumulated depreciation account should be balanced and bought forward to the next period. The depreciation amount of the next period should be added to the existing balance in the accumulated depreciation account. As a result, as at the end of any accounting period the balance in the accumulated depreciation account presents the total annual depreciation that has accumulated over the depreciated period. Hence the credit balance in the accumulated depreciation account presents the total accumulated depreciated value of the asset. This amount is deducted from the cost of the asset in the statement of the financial position.

As per the above example, motor vehicle depreciation of Rs. 80 000 and machinery depreciation of Rs. 25 000 should be included in the Profit or Loss Statement.

In the Statement of Financial Position, the accumulated depreciation of motor vehicle amount of Rs. 80 000 and accumulated depreciation of machinery amount of Rs. 25 000 should be presented as deductions from the cost of respective assets.

As this is the first year of depreciation, the depreciated amount and the accumulated depreciation amount are the same. When the amount of an accumulated depreciation of an asset is deducted from the cost of the asset, the balance is known as the carrying amount of the asset.



Activity 04

Following information are relevant to a machine acquired by a business for its production purposes.

Purchase cost of the machine	Rs. 300 000
Carriage inwards cost	Rs. 20 000
Installation cost	Rs. 90 000
Estimated useful life	10 years
Scrap value	Rs. 60 000

Do the following calculations

1. Cost of the machine
2. The depreciable value of the machine
3. If the Straight-line depreciation method is used,

   i. The annual depreciation amount

   ii. Show the journal entries to record the first year depreciation and post the same in to the ledger accounts.

5.3 Presenting the non-current assets in the Statement of Financial Position

When depreciable non-current assets of the business are to be presented in the Statement of Financial Position, such assets should be present in a format using three columns as cost, accumulated depreciation and the carrying amount. Such format is given below and observe it.

Non-current assets	Cost Rs.	Accumulated depreciation Rs.	carrying amounts Rs.
Buildings	xxx	xx	xx
Motor vehicles	xxx	xx	xx
	xxxx	xx	xx

Example :-

The accounting period of Radha's business ends on 31.12.20xx. The non-current assets the business had as at 31.12.20xx is given below;

Non current assets	Cost Rs.	Accumulated depreciation as at 01.01.20xx Rs.
Buildings	400 000	60 000
Motor vehicles	500 000	100 000
Machinery	60 000	6 000
Furniture	30 000	3 000

The non-current assets are depreciated at cost by 5% per annum and to record the depreciation, an accumulated depreciation account is maintained.

The depreciation included in the profit or loss statement as an expense relevant for the accounting period is as follows,

Building depreciation $(400\,000 \times \frac{5}{100})$ = 20 000
Motor vehicle depreciation = 25 000
Machinery depreciation = 3 000
Furniture depreciation = 1 500

The accumulated depreciation relating to the assets as at 31.12.20xx is as follows;

Non-current assets	Accumulated depreciation as at 01.01.20xx Rs.	+	Depreciation for the year Rs.	=	Accumulated depreciation as at 31.12.20xx Rs.
Buildings	60 000	+	20 000	=	80 000
Motor vehicles	100 000	+	25 000	=	125 000
Machinery	6 000	+	3 000	=	9 000
Furniture	3 000	+	1 500	=	4 500

The Non-current Assets as at 31.12.20xx is shown in the statement of Financial Position as follows;

Business of Radha
Statement of Financial Statement as at 31.12.20xx (extracts)

Non-current assets	Cost Rs.	Accumulated depreciation Rs.	carrying amounts Rs.
Buildings	400 000	80 000	320 000
Motor vehicles	500 000	125 000	375 000
Machinery	60 000	9 000	51 000
Furniture	30 000	4 500	25 500
	990 000	218 500	771 500

5.4 Preparation of Financial Statements with adjustments

The example below depicts how to prepare financial statements using the above explained adjusting entries. Observe it.

Example :-

The accounting period of Sarani's business ends on 31.12.20xx. the trial balance as at 31.12.20xx is given below.

Business of Sarani
Trail Balance as at 31.12.20xx

Description	Dr. Rs.	Cr. Rs.
Inventories as at 01.01.20xx	6 000	
Purchases	185 000	
Carriage inward expenses	4 000	
Sales		385 000
Rent expenses	20 000	
Insurance expenses	8 000	
Sales promotional expenses	14 000	
Salesman salaries	30 000	
Discount given	4 000	
Discount received		9 000
Bank loan interest	6 000	
Bank charges	2 000	
Delivery motor vehicle (at cost)	300 000	
Office equipment (at cost)	40 000	
Trade debtors	17 000	
Trade creditors		32 000
Bank loan to be settled after 3 years		50 000
Cash	20 000	
Fixed deposit (5 years)	70 000	
Capital		250 000
	726 000	726 000

Following additional information are also provided

1. Accrued expenses as at 31.12.20xx
   Insurance expenses Rs. 2 500
   Rent expenses Rs. 4 000

2. Interest receivable as at 31.12.20xx is Rs. 7 000

3. Rs.3 000 should be written off as bad debts from the trade debtors

4. Annual depreciation should be provided on the motor vehicles and office equipments on cost at 8% and 10% respectively.

5. All inventories has been sold out as at 31.12.20xx

From the above information, observe how the;

01. Journal entries relating to the adjustments
02. Profit or Loss Statement for the year ended 31.12.20xx
03. Statement of Financial Position as at 31.12.20xx have been prepared.

01. Journal entries relating to the adjustments

General Journal

Date	Journal V. No	Description	L. F.	Dr. Rs.	Cr. Rs.
31.12.20xx	001	Insurance account Dr.		2 500	
		Accrued insurance expense a/c			2 500
		(Accounting for accrued insurance expense)			
31.12.20xx	002	Rent expense account Dr.		4 000	
		Accrued rent expenses a/c			4 000
		(Accounting for the accrued rent expense)			
31.12.20xx	003	Interest receivable account Dr.		7 000	
		Interest income a/c			7 000
		(Accounting for interest receivable for the fixed deposit)			
31.12.20xx	004	Bad debts account Dr.		3 000	
		Trade debtors account			3 000
		(Accounting for bad debts)			
31.12.20xx	005	Motor vehicle depreciation account Dr.		24 000	
		Accumulated motor vehicle dep. a/c			24 000
		(Accounting for annual motor vehicle depreciation)			
31.12.20xx	006	Office equipment depreciation a/c Dr.		4 000	
		Accumulated office equipment dep. a/c			4 000
		(Accounting for annual office equipment depreciation)			

02. Profit or Loss Statement for the year ended 31st December 20xx

Sarani's Business
Profit or Loss Statement
For the year ended 31st December 20xx

	Rs.	Rs.	Rs.
Sales			385 000
Less: cost of sales			
Inventory as at 01.01.20xx		6 000	
Purchases		185 000	
Carriage inward expense		4 000	(195 000)
Gross Profit			190 000
Add : other income			
Discount received		9 000	
Interest income		7 000	16 000
			206 000
Less : expenses			
Distribution expenses			
Sales promotional expenses	14 000		
Salaries to sales personnel	30 000		
Discount given	4 000		
Motor vehicle depreciation	24 000		
Bad debts	3 000	75 000	
Administration expenses			
Rent expense	24 000		
Insurance expense	10 500		
Depreciation office equipment	4 000	38 500	
Financial expenses			
Bank loan interest expense	6 000		
Bank charges	2 000	8 000	(121 500)
Net profit			84 500

03. Statement of Financial Position as at 31st December 20xx

Sarani's Business
Statement of Financial Position
As at 31st December 20xx

	Cost Rs.	Accumulated dep. Rs.	Carrying amounts Rs.
Non current assets			
Motor vehicles	300 000	24 000	276 000
Office equipments	40 000	4 000	36 000
	340 000	28 000	312 000
Fixed deposit (5 years)			70 000
			382 000
Current assets			
Trade debtors		14 000	
Interest receivable		7 000	
Cash		20 000	41 000
Total assets			423 000
Capital 01.01.20xx		250 000	
Add: net profit		84 500	334 500
Non current liabilities			
Bank loan			50 000
Current liabilities			
Trade creditors		32 000	
Accrued insurance expense		2 500	
Accrued rent expense		4 000	38 500
Equity and liabilities			423 000

In the example above, Sarani's business has sold the entire stock that was presented for sale, as a result, there is no closing stock and the entire stock that was presented for sale has been turned in to cost of sales.

Example :-

The accounting period of Kanishka's business ends on 31.12.20xx
The trial balance as at 31.12.20xx is given below

Description	Dr. Rs.	Cr. Rs.
Sales		520 000
Inventory as at 01.01.20xx	18 000	
Purchases	230 000	
Machinery (at cost)	80 000	
Delivery motor vehicle (at cost)	600 000	
Trade debtors	36 000	
Trade creditors		44 000
Bank loan at 10% payable after 4 years		120 000
Bad debts	4 000	
Accumulated depreciation as at 01.01.20xx		
Motor vehicles		90 000
Machinery		16 000
Drawings	18 000	
Fixed deposit (5 years)	80 000	
Stationery expenses	9 000	
Electricity	12 000	
Selling expenses	35 000	
Cash	18 000	
Capital as at 01.01.20xx		350 000
	1 140 000	1 140 000

Additional Information are provided below;

1. Closing stock as at 31.12.20xx is valued at Rs. 24 000.
2. The fixed deposit balance is available from the beginning of financial period. 10% annual interest rate is applicable for this fixed deposit.
3. Interest for the bank loan for the year end 31.12.20xx has been accrued.
4. It has been decided to write off further Rs.2 000 as bad debts.
5. Depreciation has to be provided annually at 10% on motor vehicles and machinery.

Using the above information, Profit or Loss Statement for the year ended 31.12.20xx and Statement of Financial Position as at 31.12.20xx has been prepared. Go through the statements.

Business of Kanishka
Profit or Loss Statement
For the year ended 31.12.20xx

Sales			520 000
Less: cost of sales			
Stock as at 01.01.20xx		18 000	
Purchases		230 000	
Cost of goods to be sold		248 000	
Less: stock as at 31.12.20xx		(24 000)	(224 000)
Gross profit			296 000
Interest income			8 000
			304 000
Distribution expenses			
Bad debts	6 000		
Motor vehicle depreciation	60 000		
Selling expenses	35 000	101 000	
Administration expenses			
Depreciation of machinery	8 000		
Stationery expenses	9 000		
Electricity expenses	12 000	29 000	
Financial expenses			
Bank loan interest	12 000	12 000	(142 000)
Net profit			162 000

Business of Kanishka
Statement of Financial Position as at 31.12.20xx

	Cost Rs.	Acc. dep. Rs.	Carrying amounts Rs.
Non-current assets			
Motor vehicles	600 000	150 000	450 000
Machinery	80 000	24 000	56 000
	680 000	174 000	506 000
Fixed deposit (5 years)			80 000
			586 000
Current assets			
Closing stocks		24 000	
Trade debtors		34 000	
Interest receivable		8 000	
Cash		18 000	84 000
Total Assets			670 000
Capital as at 01.01.20xx		350 000	
Add: net profit		162 000	
		512 000	
Less: drawings		(18 000)	494 000
Noncurrent liabilities			
Bank loan at 10%			120 000
Current liabilities			
Trade creditors		44 000	
Accrued bank loan interest		12 000	56 000
Equity and liabilities			670 000

Activity 05

The trail balance as at 31.12.20xx of Sahan Abeynayakas' business is as follows;

Description	Dr. Rs.	Cr. Rs.
Capital 20xx.01.01		300 000
Purchases and sales	340 000	660 000
Trade debtors & trade creditors	65 000	82 000
Administration salaries	34 000	
Sales staff salaries	42 000	
Carriage inwards	12 000	
Closing stock as at 01.01.20xx	28 000	
Discounts given and discounts received	5 000	8 000
Fixed deposit at 8%	150 000	
Traveling expense	5 000	
Delivery vehicles (at cost)	500 000	
Sales promotional expenses	7 000	
Furniture and fittings (at cost)	60 000	
Bank loan at 12% (payable after 5 years)		200 000
Bank interest paid in cash	12 000	
Accumulated depreciation as at 01.01.20xx		
Delivery vehicle		50 000
Furniture and fittings		12 000
Electricity	8 000	
Cash in hand and bank balance	44 000	
	1 312 000	1 312 000

Prepare the financial statements considering the following information;

1. Value of closing stock as at 31.12.20xx is Rs. 30 000.
2. Accrued expenses as at 31.12.20xx are as follows;
   Administration expenses Rs. 2 000
   Electricity Rs. 6 000
3. Write off Rs.1 000 as bad debts as at 31.12.20xx
4. Depreciation should be provided at cost at 10% for the delivery vehicle and furniture and fittings annually.

Activity 06

The trial balance of Nadeeka's business as at 31.12.20xx is given below

Purchases	350 000	
Sales		725 000
Buildings (at cost)	300 000	
Equipment (at cost)	40 000	
Accumulated depreciation as at 01.01.20xx		
Buildings		45 000
Equipments		6 000
Loading expenses	13 000	
Inventory as at 01.01.20xx	30 000	
Discounts given	8 000	
Discounts received		5 000
Insurance expenses	6 000	
Sales promotional expenses	42 000	
Bank loan		80 000
Interest on bank loan	8 000	
Bad debts	4 000	
Trade debtors	70 000	
Trade creditors		52 000
Cash	292 000	
Capital as at 01.01.20xx		250 000
	1 163 000	1 163 000

Additional information are given below;

1. Closing stock as at 31.12.20xx is Rs. 40 000
2. Accrued expenses as at 31.12.20xx
   Insurance expenses 2 000
   Sales promotional expenses 3 000
3. Building and equipments must be depreciated at 5% per annum.

Required;

1. Profit or Loss Statement for the year ended 31.12.20xx
2. Statement of Financial Position as at 31.12.20xx.

Chapter 06

Not for Profit Organizations

This chapter discusses the followings.

6.1 Introduction to not for profit organizations

6.2 Financial statements of not for profit organizations



6.1 Introduction to not for profit organizations

As the word ‘business” is heard, the term “profit” automatically comes to our mind. The reason for this is that most of the business organizations operate their businesses with a profit motive. But there are some organizations that function with different purposes rather than focusing on the profits. Social welfare is one of the purposes of such organizations.

You can think about such organizations that you have been involved and organizations that you have know in your school. Commerce association, Sinhala and Tamil Literary associations, Buddhist, Hindu, Islamic and Christian associations are some of them.

Further, you can think about different associations that function in your living area. Sometimes your mother, father or brother may be a member of such an organization. Sports clubs, women’s associations, rural development associations and welfare associations are some of the examples for such organizations.

By observing the activities of such organizations we can arrive at a common conclusion that such associations function with a purpose of enhancing social welfare and wellbeing.

In accounting, such organizations are termed as Not for Profit organizations.

Social services, funding for floodvictims, drought aids, scholarships and student funds are some of the activities that these organizations perform to fulfill their purposes.



Activity 01

01. Prepare a list of not for profit organizations that operates in your area or in your school.

02. Specify the activities that the above not for profit organizations carry out to make their objectives a reality.

6.2 Financial statements of a not for profit organization

There should be an adequate income to maintain the daily operations of these not for profit organizations. For this purpose, such organizations have to use different means to earn an income. It is also necessary that such organizations have to bear expenses in conducting the operations of the organizations.

Examples :-

Collection of subscription

Sale of flags

Conduct entertainment events and functions

Conducting cafeterias

Organizing different competitions

Organization of exhibitions

Donations from different organizations



Figure 6.1

As explained above, it is clear that even the organizations that run without a profit motive conduct financial activities. Thus, these financial activities should be recorded appropriately to achieve following objectives.

- To raise awareness among the members of the society and other stakeholders
- To maintain the trust of the members
- To plan the future activities of the organization
- To conduct the operations of the organization smoothly

In order to meet the above objectives, the not for profit organizations prepare financial statements. In order to prepare the financial statements at the end of the accounting period, all the transactions that occur in an organization must be recorded. Some organizations keep accounts properly for this purpose while some organizations do not. However, every organization should maintain an account to record all the cash receipt and payments.

Receipt and payment account

Receipt and payment account is the account that all the cash receipts and payments occurred within an accounting period in a not for profit organization is recorded. This is very similar to the cash book prepared in a profit oriented organization. This is an asset account. All cash receipts are debited to the receipt and payment account while all cash payments are credited. The difference between cash receipts and payments is the cash balance available at the end of the period.

Following objectives can be achieved by preparing a receipt and payment account.

- ☆ To know the cash balance at the end of an accounting period
- ☆ To manage cash properly
- ☆ To minimize fraud and misuse of cash
- ☆ To utilize cash reserves more productively to achieve the organizational objectives
- ☆ To obtain information regarding the sources of cash receipts and payments

Cash receipts and payments due are recorded in the cash receipt and payment book on a daily basis as they occur. A summary of receipts and payments are prepared and presented with financial statements of the not for profit organizations. As a result, a summarized statement of cash receipt and payment account is considered as an element of the financial statements of a not for profit organization.

Preparation of receipt and payment account

Example :-

A summary of cash receipt and payments of the Commerce Society of the Doramadalawa Maha Vidyalaya for the year ended 31.12.20xx is given below.

Receipts	Rs.	Payments	Rs.
Subscriptions received	6 200	Printing of magazines	2 800
Proceeds from sale of magazines	4 100	Stationery	800
Donations	2 300	Transport expenses	200
Advertisements	14 400	Donations paid	400

Using the above information, preparation of the cash receipt and payment account can be discussed as follows;

Commerce Society
Cash Receipt and Payment Account
For the year ended 31.12.20XX

Subscription	6 200	Printing of magazines	2 800
Magazine sales	4 100	Stationery	800
Donation	2 300	Transportation	200
Advertisements	14 400	Donation	400
		Balance c/d	22 800
	27 000		27 000
Balance b/f	22 800		

Example :-

Summarized information relating to cash receipts and payments of Dirisaviya Community Association for the year ended 31st December 20XX is given below;

Cash balance as at 01.01. 20XX Rs. 12 300
Subscription received Rs. 27 000
Rent expenses Rs. 12 000
Donation from government Rs. 150 000
Ceremony expenses Rs. 11 400
Payment for fruit plants Rs. 4 200
Fertilizer expenses Rs. 3 500
Interest income Rs. 15 000
Interest for bank loan Rs. 1 200
Purchase of equipment Rs. 12 000
Payment of salaries Rs. 10 000
Electricity Rs. 400
Advertising Rs. 6 200
Transportation expenses Rs. 1 700

Observe how the receipt and payment account has been prepared based on above information.

Diri Saviya Community Association
Receipt and Payment Account
for the year ended 31st December 20XX

Balance b/f	12 300	Rent expense	12 000
Subscription fees	27 000	Ceremony expenses	11 400
Donations	150 000	Fruit plants	4 200
Interest Income	15 000	Fertilizer	3 500
		Interest expense	1 200
		Equipment	12 000
		Salaries	10 000
		Electricity	400
		Advertisement	6 200
		Transportation	1 700
		Balance c/d	141 700
	204 300		204 300
Balance b/f	141 700		

Activity 02

Given below is the cash receipt and payment account prepared by the treasurer of the Shakthi Sports Club. After balancing the cash receipt and payment account a credit balance of Rs. 78 300 existed in the account, but physically Rs. 26 900 worth of cash of the sports club was there with him. Check the given cash receipt and payment account for any corrections and prepare the corrected cash receipt and payment account.

Shakthi Sports Club
Cash Receipt and Payment Account
For the year ended 31.12.20XX

Subscription fee	190 000	Balance b/f	7 400
Purchase of sports equipments	40 000	Salaries and wages	99 000
Balance c/d	78 300	Donation received	24 300
		Sale of flags	8 200
		Refreshment expenses	5 400
		Stationeries	7 500
		Purchase of equipments	4 800
		Printing charges for flags	5 600
		Miscellaneous expenses	15 000
		Maintenance of ground	8 200
		Fees for umpiring	17 500
	308 300		308 300

Activity 03

Pubudu Children's community has 450 members. The subscription fee per member is Rs. 100. A summary of cash transactions relevant to month of January 20XX is given below.

	Rs.
Purchase of stationery	2 400
Expenses for internet facilities	70
Income from selling magazines	6 400
Postal expenses	60
Transport expenses	200
Printing expenses	700
Receipt of donations	1 000

Following additional information is also available

Income of Rs 200 from magazine sales is yet to be received.
15 members have not paid their membership fees for the month of January 2015

Using the given information, prepare the cash receipt and payment account for the month of January 20XX of Pududu Children community.



Activity 04

Below given are the receipts and payments for the first three months of year 20xx recorded by the treasurer of the Samagi Youth club. Prepare the cash receipt and payment account using the information given.

Balance of cash in hand as at 20xx.01.01 is Rs. 12 400

		Rs.			Rs.
04.01	Salaries-administration	10 200	28.02	Anniversary expenses	11 400
07.01	Subscription fee	3 200	03.03	Stationery expenses	300
10.01	Electricity expenses	1 400	07.03	Purchase of papers	600
15.01	Rates and taxes	300	10.03	Donation received	20 000
20.01	Subscription fees	7 300	10.03	Income from carnivals	94 200
23.01	Match referee fee	1 500	13.03	carnival expenses	27 500
30.01	Transportation fee	1 200	16.03	Income from carnivals	42 200
01.02	Subscription fees	15 800	20.03	Rate and taxes	300
05.02	Receipt of donation	4 000	21.03	Electricity	1 300
10.02	Salaries -administration	10 200	22.03	Receipt of donations	15 000
13.02	Stationery expenses	400	24.03	Match referee fee	1 500
15.02	Electricity expenses	1 200	25.03	Payment for papers	1 200
20.02	Subscription fees	9 600	28.03	Subscription fee	8 000
24.02	Transportation fee	5 000	29.03	Expenses for carnivals	1 800
26.02	Subscription fees	17 200	30.03	Water bill	1 300

Income statement

An income statement is prepared to calculate the net result of the economic activities conducted by the not for profit organizations. This statement will calculate the excess or the deficit generated by a not for profit organization within a specific time period, considering all the income and expenses relating to the relevant period. An surplus is generated in the income statement when the income generated is more than to the expenses of the period. When the expenses are more than to the income generated a deficit is recognized.

Differences can be recognized between the receipt and payment account and the income statement prepared by the not for profit organizations. Some differences are given below.

Receipt and Payment Account	Income Statement
Very much similar to the cash book	Similar to Profit or Loss Statement
Records the cash receipts and payments	Records only income and expenses
Records all the cash receipts and payments relating to the time period	Records income and expenses relating only to the time period
Shows the cash balance available at the end of the period	The balance will represent either an excess or a deficit
Prepared on cash basis	Prepared on accrual basis

Subscription fees

Main source of income for the not for profit organizations is the subscription income. The subscription fees can be charged monthly, quartly, bi-annually or annually. Members who are willing to make a lump sum payment for their entire membership can obtain life time membership period by making a onetime payment.

The total annual subscription income can be calculated as follows;

Annual Subscription Income = No. of members x *Annual membership fee per member*

Example :-

The Commerce Society of Sathmini Maha Vidyalaya has 420 members. The annual membership fee per member is Rs 60.
The annual subscription fee is,

No. of members X Annual membership fee per member
= 420 X Rs. 60
Rs. 25 200

Example :-

The annual membership fee of a sports association is Rs 200 per member. The total number of members are 400 and 20 members have not paid their annual membership fee.

	Subscription fees	+	Subscription fees in arrears
	380 X 200		20 X 200
	Rs. 76 000		Rs. 4 000
Subscription fees for the year			Rs. 80 000



Activity 05

Seasath Sports Society has 120 members for the year 20XX. The annual membership fee per member is Rs. 350. 15 members have not paid their subscription fees as at the end of the year.

1. Calculate the subscription fee received for the year 20XX
2. How much is the accrued membership fee for the year 20XX
3. Calculate subscription fee for the year 20XX

Preparation of income statement

Using the below example, observe how to prepare the income statement

Example :-

The treasurer of the Science Association of Medawala Maha Vidyalaya, has presented the information relating to Income and Expenses for the year 20XX as below;

Income	**Rs.**	**Expenditure**	**Rs.**
Membership fee	25 200	Printing of magazines	2 800
Sale of magazines	4 100	Stationeries	800
Donation	2 300	Transportation	200
Advertisements	14 400	Payments as donation	400

The income statement is prepared using the above information is shown below.

Science Society of the Sesath Maha Vidyalaya
Income Statement
For the year ended 31.12.20XX

	Rs.	Rs.
Income		
Membership fees	25 200	
Sale of magazines	4 100	
Donations	2 300	
Advertisements	14 400	46 000
Less : expenses		
Printing of magazines	2 800	
Stationery	800	
Transportation	200	
Payments as donations	400	4 200
Surplus		41 800

Example :-

Observe how the Income statement has been prepared by the treasurer of Janajaya Society by using following data.

	Rs.		Rs.
Cash balance 01.01.20xx	12 300	Sale of flags	86 400
Membership fees received	74 300	Electricity	1 450
Payments as donation	1 200	Purchase of papers	1 280
Stationery purchases	520	Telephone expenses	720
Receipt of donations	40 000	Sale of old papers	200
Payments for aids	2 500	Rent of building	7 000
		Refreshment expenses	640

Additional information

1. Number of members are 746 and the annual membership fee per member is Rs. 100. However, 03 members have not paid membership fees
2. Annual telephone charge is Rs. 840
3. Rs. 1 600 is to be received from the sales of flags
4. Prepaid electricity expense is Rs. 150

Janajaya Society
Income Statement
For the year ended 31.12.20XX

	Rs.	Rs.
Income		
Membership fee	74 600	
Sales of old papers	200	
Donations	40 000	
Flag sales	88 000	202 800
Less : expenses		
Payments for donations	1 200	
Stationery	520	
For papers	1 280	
Telephone expenses	840	
Payments for aids	2 500	
Electricity expenses	1 300	
Building rent	7 000	
Refreshment expenses	640	15 280
Surplus		187 520

Activity 06

Chintana Readers Club of has 30 members. The annual membership fees per member is Rs. 300. The treasurer of the club has presented a summary of the receipt and payment account as at 31.12.20XX.

Receipt and Payment Account

01.01.20xx bank balance	1 500	Telephone expenses	1 200
Membership fees received	12 000	Building rent	1 600
Building rent	9 370	Refreshment expenses	2 200
Sales of magazines	5 600	Equipment maintenance	3 500
		Stationeries	350
		Transport expenses	1 200
		Printing expenses	6 100
		Balance c/d	12 320
	28 470		28 470

Following information are also given

1. Building rent payable is Rs. 400
2. Building rent received in advance Rs. 200
3. The club has equipment amounting to Rs.8 000 which need to be depreciated at 5%
4. Prepaid printing expense is Rs. 600

Prepare the Income Statement of Chintana Readers Club for the year ended 31.12.20XX

Activity 07

The treasurer of Liyasevana women organization has presented you, a summary of cash transactions relating to the year ended 31.12.20XX

	Rs.		Rs.
Cash balance 01.01.20XX	30 000	Purchase of magazines	600
Subscriptions received	75 000	Sale of magazines	400
Building rent	30 000	Purchase of furniture	7 500
Telephone charges	7 500	Refreshment expenses	2 000
Purchase of equipments	25 000	Receipt from well wishers	23 000
Labor cost	2 800	Transportation cost	1 200

Additional information

01. Number of members are 400. Membership fees per member is Rs. 200.

02. Telephone charges of Rs. 600, refreshment expenses of Rs. 1 500 have to be paid.

03. The rent payment includes Rs. 5 000 paid for the next year

04. The book value of non-current assets as at 31.12.20xx is as follows;

Equipments	Rs. 24 500
Furniture	Rs. 7 125

Prepare

1. The receipt and payment account for the year ended 31.12.20XX
2. Income statement for the year ended 31.12.20XX



Activity 08

Summarized Statement of Receipt and Payment account for the Shakthi Sports Club for the year ended 31.12 20XX is presented below

Receipt and Payment Account

Cash balance 01.01.20xx	1 500	Stationery	1 100
Subscription fees received	12 870	Renovation of ground	1 600
Renting of ground	22 500	Rates	6 600
Ticket sales	7 300	Salaries and wages	11 200
		Electricity	2 400
		Match expenses	3 500
		Balance c/d	17 770
	44 170		44 170

Additional information

01. Annual per membership fee is Rs. 400. 12 members have have not yet paid their subscription fees for the current year

02. The value of Sports equipments at the beginning of the period was Rs. 64 200 and at the end of the period the value has been estimated as Rs. 58 800

03. Taxes and rates payable is Rs. 800

04. Income received in advance for the sports ground is Rs. 2 500

Using the given information prepare the Income Statement for the year ended 31.12.20XX

Chapter 07

Statement of Production Cost

This chapter discusses the followings.

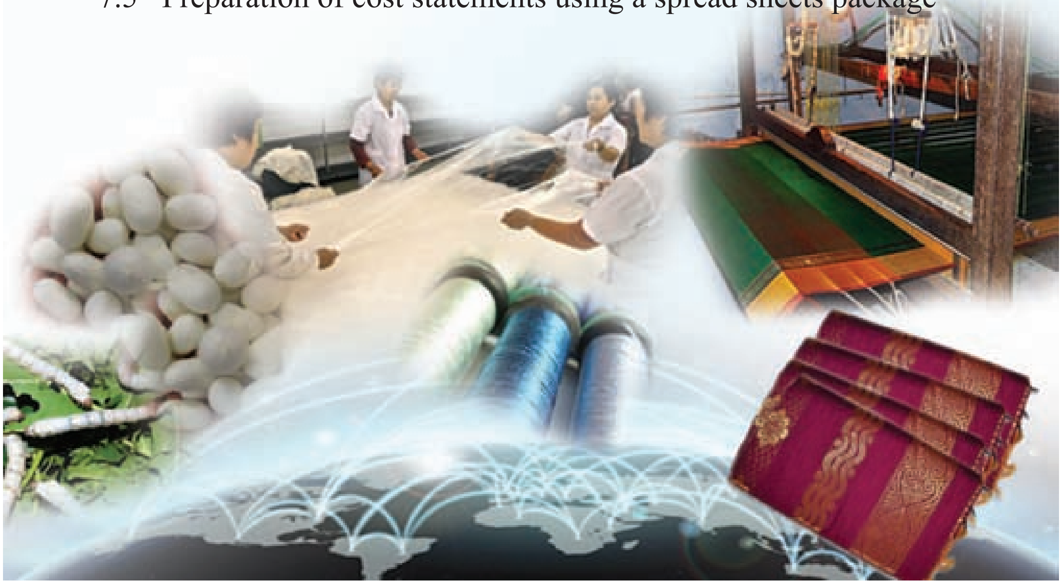
7.1 Introduction to production cost

7.2 Elements of product cost

7.3 Calculation of product cost

7.4 Preparation of statements on the production costs

7.5 Preparation of cost statements using a spread sheets package



7.1 Introduction to production costs

Today there are large number of business organizations that engage in retail businesses as well as manufacturing and trading businesses. Organizations that produce goods for resale purposes are known as manufacturing organizations. The key function of a manufacturing organization is to produce goods and services using the economic resources. Hence, in order to produce a good or service, use of economic resources is a must and such consumption of economic resources essentially involves a cost.

Production cost can be defined as the total production cost that is incurred within a specified period of time.

7.2 Elements of production cost

The production cost can be mainly classified as the direct cost and indirect cost depending on how the cost links with the product or on the nature of the cost. The indirect costs are also known as the production overhead cost. The below given are the elements of production costs.

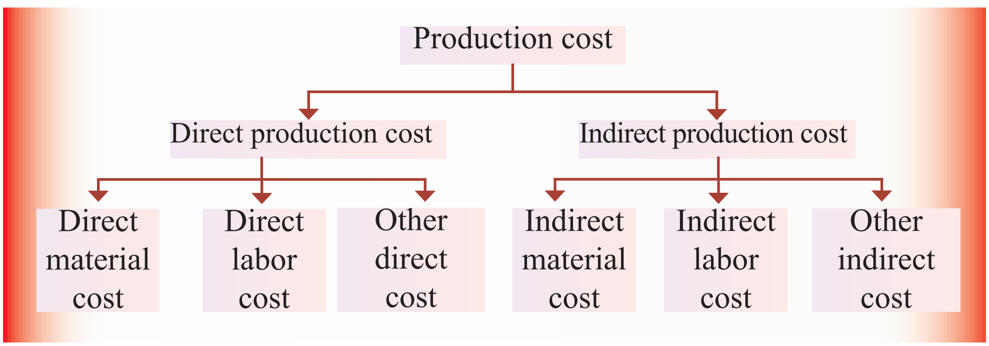


Figure 7.1 Elements of production cost

Direct production cost

The costs that can be directly identified with the unit of production is regarded as the direct cost. These are directly relates to the production of goods.

The direct cost can be identified in three elements

- Direct material cost
- Direct labor cost
- Other direct costs

Direct material cost

Direct material cost is the cost of physical resources that can be directly identified with the unit of production.

Examples:-

Paper and ink used by a book publishing company
The wood that is used in making a wooden table

Direct labor cost

Direct labor cost are the wages that are incurred in order to produce specific goods or to provide specific services to customers. This includes all the payments for the workers who are directly involved in the process of converting the inputs in to outputs.

Examples:-

The salaries for book printing staff
Carpenter cost in making a wooden table

Other direct costs

Direct costs that are incurred in the production of a good other than the direct materials and direct labor is called other direct costs.

Example:-

The royalty payment made to an author of a book

Prime cost

The total of direct materials, direct labor and other direct expenses in producing a product is known as the total direct cost or the prime cost.

Prime cost = Direct material cost + Direct labor cost + Other direct costs

Example:-

As per the examples discussed, the prime cost of book printing press can be calculated as follows;

		Rs.
Direct materials (printing papers and Ink)	=	xx
Direct labor (wages to printing machine operator)	=	xx
Other direct costs (royalties paid to author)	=	xx
Prime cost	=	xxx

Example:-

Below are the expenses relevant to Ranuka Book Printing Press. Calculate the printing cost using following information.

Printing paper Rs. 40 000
Ink Rs. 5 000
Printing machine operator wages Rs. 15 000
Royalties paid to author (Rs.150 each for 100 books) Rs. 15 000

Prime cost = Direct material cost + Direct labor cost + Other direct cost
= 45 000 + 15 000 + 15 000
= Rs. 75 000

Indirect production cost (overhead production cost)

Costs that are incurred for the overall production process but cannot directly be identified with a unit of production, is known as production overhead costs. This includes all the production costs except the prime cost.

The elements that identified relating to the production overhead cost are;

- Indirect materials cost
- Indirect labour cost
- Other indirect costs

Indirect material cost

The costs that are incurred for materials that cannot be directly recognized with a unit of production is known as the indirect material cost.

Examples:-

Lubricating oil for book printing machines
Expenses incurred for the sand papers in making a table

Indirect labor cost

This is the labor cost incurred for the employees who are not directly involved with production process.

Example:-

Salaries paid to factory supervisor
Salaries paid to office staff

Other indirect costs

All other indirect costs incurred in the production other than the direct materials and direct labour is known as other indirect cost.

Examples:-

Factory rent
Factory insurance expense

Production overhead cost = Indirect material cost + Indirect labor cost
+ Other indirect costs

Example:-

The production overhead cost can be calculated as follows as per the examples discussed above;

Indirect material cost (Lubricating oil for book printing machines)	=	XX
Indirect labor cost (Salaries for supervisor and office clerk)	=	XX
Other indirect expenses (factory rent, factory insurance)	=	XX
Total production overhead cost	=	XXX

Example:-

With reference to the Ranuka book printing press, the press has incurred Rs. 12 000 for lubricating oil, Rs. 20 000 for supervising salaries, Rs. 30 000 and Rs. 15 000 for factory rent and insurance.

Accordingly the overhead cost is;

Indirect materials + Indirect labour + Other indirect costs
= Rs. 12 000 + Rs. 20 000 + Rs. 45 000
= Rs. 77 000

The classification of production cost in to direct and indirect may depend on the decision of the management of the organization.

Activity 01

Classify the given cost below in to direct and indirect

Production	Expense	Direct	Indirect
Shoes	Leather Nails and polish Salary for the shoe maker Machine maintenance cost		
Bread	Wheat flour Water expense Salary to bread baker Salary to watchman		

Activity 02

Piyumal is an established furniture designer. He operates a small furniture designing shop in a rented building. He paints every carving designs well. He has two furniture designers working under him. He also gets a service of a management assistant. The wood that is required for the furniture shop is transported to the business premises by a hired lorry.

01. Make a list of costs that is relevant for the furniture design business and classify them in to direct and indirect.

02. Calculate the prime cost and the overhead cost assuming values for the costs you have identified in (i) above.

Activity 03

Following are the costs relating to a specific month of "Rasameewitha" a sesame rolls (thala karali) manufacturing company

	Rs.		Rs.
Materials cost	80 000	Salaries to watchman	7 000
Labor cost	20 000	Expenses for flavors	1 500
Packing cost	4 000	Electricity	1 500
Factory rent	11 000	Maintenance of machinery	5 000

Calculate the prime cost and the overhead cost using the above information.

7.3 Calculation of production cost

Total production cost

The total cost incurred for producing a specific good is known as the total production cost.

$$\text{Total production cost} = \text{Prime cost} + \text{Production overhead cost}$$

Per unit production cost

Cost relating to a unit of product is known as the per unit production cost. Per unit cost of production is calculated as follows:

$$\text{Per unit cost} = \frac{\text{Total production cost}}{\text{Total number of units produced}}$$

Per unit profit margin

When a manufacturing organization manufactures a product, they present the product to the market by adding a specific margin to its cost. This specific margin is termed as the "profit margin". When deciding on the profit margin, the customer attractiveness and the impact on the company's going concern have to be considered.

If the profit margin is high, the price of the product will be high and accordingly the customer demand for the product will decrease.

When the profit margin is set low, the price of the product will decrease and the customer demand for the product will increase. However, the profits of the business may decrease.

Per unit selling price

The price at which a product is presented to the market is the per unit selling price. The calculation of the selling price is as follows;

$$\text{Per unit selling price} = \text{Per unit cost} + \text{Per unit profit margin}$$

When a manufacturing organization adds a certain profit margin to its cost to decide on the product price, it is called as cost based pricing.

Even though the prime factor in making a pricing decision is cost, there are other factors that should be considered in making pricing decisions;

- The demand for the product in the market
- The prices of similar products and substitutes in the market
- Pricing policy of the organization
- Legal factors

Following example demonstrates the calculation of the total production cost, per unit cost, per unit profit margin, and per unit selling price of a particular product.

Example:-

A manufacturing plant has following expenses relating to its production

Prime cost Rs. 120 000
Production overhead cost Rs. 80 000
Number of units produced 200
Profit margin on total cost per unit 10%

01. Total production cost

Prime cost + Production overhead cost
= Rs. 120 000 + 80 000
= Rs. 200 000

02. Per unit cost

$$\text{Per unit cost} = \frac{\text{Total cost}}{\text{Number of units produced}}$$

$$= \frac{200\,000}{200}$$

= Rs. 1 000

03. Per unit selling price

Per unit selling price = Per unit cost + Per unit profit margin

$$= 1\ 000 + 1\ 000 \times \frac{10}{100}$$

$$= 1\ 000 + 100$$

$$= \text{Rs. } 1\ 100$$

Example:-

Following information relates to a wardrobe manufacturer for the month of January.

Total production cost is Rs. 400 000
Number of wardrobe production during the month is 100 units
Company keeps a profit margin of 20% on cost.

Using the information above, Study the calculation of;

01. Cost of a wardrobe
02. Selling price of a wardrobe

Per unit cost of a wardrobe $= \dfrac{\text{Total cost}}{\text{Number of units produced}}$

$$= \frac{400\ 000}{100}$$

$$= \text{Rs. } 4\ 000$$

Per unit profit margin of a wardrobe $= 4\ 000 \times \dfrac{20}{100} = \text{Rs. } 800$

$$= \text{Rs. } 800$$

Selling price of a wardrobe = Per unit cost + Per unit profit margin

$$= 4\ 000 + 800$$

$$= \text{Rs. } 4\ 800$$

7.4 Preparation of production cost statement

Let us discuss on how to prepare a product cost statement for a specific period of time using the cost elements we discussed above.

The cost information relating to Ranamayura furniture manufacturers for the month of December 20xx is given below;

	Rs.		Rs.
Wood	120 000	Factory rent	12 000
Labor cost of carpenters	40 000	Fuel and electricity	8 000
Other direct costs	15 000	Factory insurance	14 000
Nail and polish	5 000	Machine depreciation	6 000
Supervisor remuneration	30 000		

The company has produced 250 chairs during the year and keeps a profit margin of 20% on cost per chair.

Study the production cost statement prepared for the month of December 20xx of Ranamayura furniture manufacturers.

Ranamaura Furniture Manufacturers
Production cost statement
For the month of December 20xx

Prime cost		
Direct materials - wood	120 000	
Direct labor - labor cost of carpenters	40 000	
Other direct expenses - other direct costs	15 000	175 000
Production overhead cost		
Indirect material costs - nail and polish	5 000	
Indirect labor - supervisor remuneration	30 000	
Indirect other expenses - factory rent	12 000	
Fuel and electricity	8 000	
Factory insurance	14 000	
Machine depreciation	6 000	75 000
Total production cost		250 000

$$\text{Per unit cost} = \frac{\text{Total Cost}}{\text{Number of units produced}}$$

$$= \frac{250\ 000}{250}$$

Production cost per wardrobe = Rs. 1 000

Selling price per wardrobe = Per unit cost + Profit margin per unit

$$= 1\ 000 + 1\ 000 \times \frac{20}{100}$$

$$= 1\ 000 + 200$$

$$= \text{Rs. } 1\ 200$$

Activity 04

01. List the benefits that a manufacturing organization can achieve by preparing the product cost statement.

02. Following are the costs relevant for " Piyasa roofing tile" (Pvt) Ltd, a roof tile manufacturing company for the year 20xx.

	Rs.		Rs.
Material purchases	353 500	Direct other cost	10 000
Production labor cost	85 000	Salaries for security service	20 000
Supervisor salaries	48 000	Machinery depreciation	7 000
Factory electricity	12 000	Factory insurance	3 000
Costs of paint	5 000	Factory maintenance cost	5 000

The company has produced 100 000 units of roofing tiles and hopes to earn a 10% of profit margin on a roofing tile.

Prepare a statement of production cost for the month of January 20XX, including the following information for " Piyasa roofing tile" (Pvt) Ltd.

1. Prime cost
2. Production overhead cost
3. Total production cost
4. Per unit selling price

Activity 05

Classify the below given costs of a shoe manufacturing company in to elements of production cost

i. Cost of leather and thread
ii. Salaries for shoe maker
iii. Factory rent
iv. Royalty charge of Rs. 20 per shoe paid for the shoe design
v. Salary of factory watchman
vi. Cost of adhesives

Activity 06

Given below are the cost information relating to an apparel business "Nawaliya" for the month of November 20xx

	Rs.
Materials purchased	64 000
Salary of the machine operator	20 000
Wages for the supervisor	23 000
Salary of the watchman	12 000
Repair of sawing machine	8 500
Fuel for factory	1 500
Rent for buildings	7 500
Electricity cost	2 500
Value of sawing machines	500 000

The apparel production for the month of November is 100 units and company keeps a profit margin of 15% from each unit. All the materials purchased have been fully utilized.

The sewing machines are depreciated at 12% annualy.

You are required to prepare the product cost statement for the month of November 20XX.

7.5 Preparation of a product cost statement using a computer spreadsheets package

The aim of this chapter is to gain the knowledge on preparing a production cost statement using computer spreadsheet package. There are few steps to be followed;

01. Open a spread sheet package.

02. Entry of the cost statement in to the spreadsheet opened

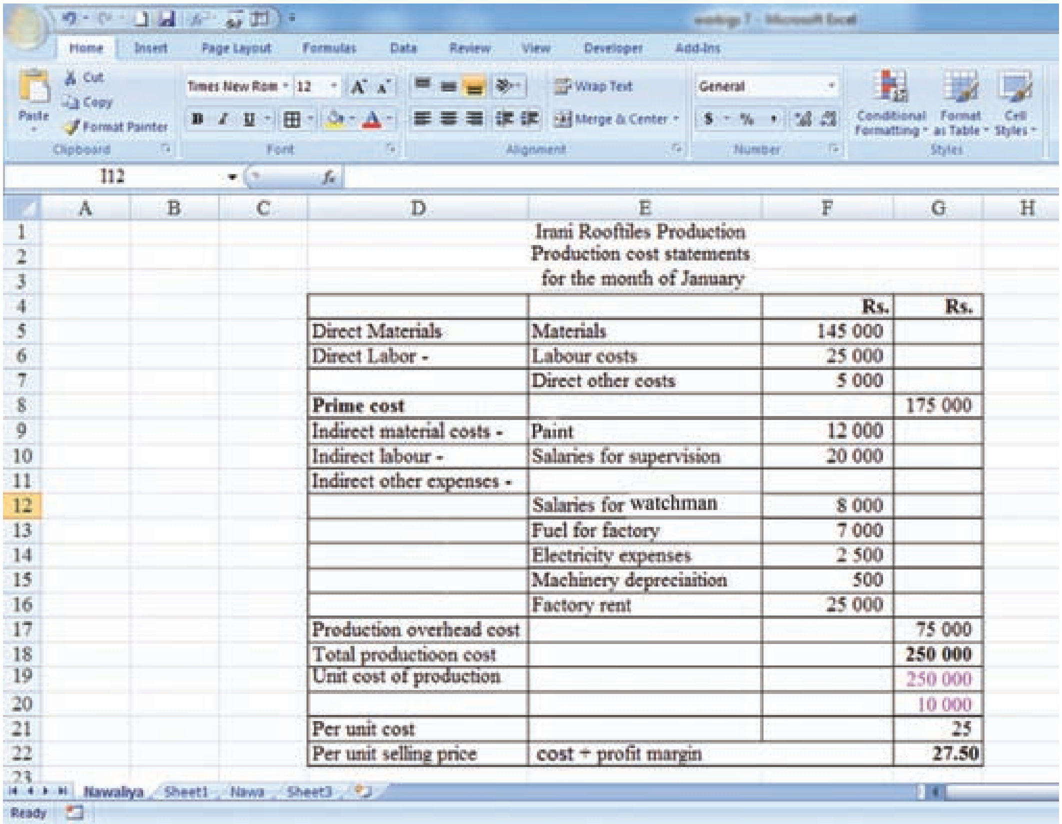
03. Use (Σ) or (Sum) command to get the total of prime cost and production overhead costs

04. In order to obtain per unit cost, enter the total cost and total units of production in to the spread sheet and use division command.

'Irani' roof tile producing company has listed the costs incurred for the month of January 20XX.

	Rs.
Direct materials	145 000
Direct labour cost	25 000
Other direct costs	5 000
Paint	12 000
Wages for supervision	20 000
Salary of the watchman	8 000
Fuel for factory	7 000
Electricity expenses	2 500
Machinery depreciation	500
Factory rent	25 000

The roof tile production for the month of January is 10 000 units and each roof tile expect to earn a 10% of profit margin.



Irani Rooftiles Production			
Production cost statements			
for the month of January			
		Rs.	**Rs.**
Direct Materials	Materials	145 000	
Direct Labor -	Labour costs	25 000	
	Direct other costs	5 000	
Prime cost			175 000
Indirect material costs -	Paint	12 000	
Indirect labour -	Salaries for supervision	20 000	
Indirect other expenses -			
	Salaries for watchman	8 000	
	Fuel for factory	7 000	
	Electricity expenses	2 500	
	Machinery depreciaition	500	
	Factory rent	25 000	
Production overhead cost			75 000
Total productioon cost			**250 000**
Unit cost of production			250 000
			10 000
Per unit cost			25
Per unit selling price	cost + profit margin		**27.50**

Chapter 08

Investments

This chapter discusses the followings.

8.1 Introduction to investment

8.2 Factors to be considered when selecting an investment method

8.3 Different types of investment methods

8.4 Returns of different investment methods



8.1 Introduction to investment

If a person does not spend the entire income earned, a portion of the income is be saved. If such saved money is kept as cash in hand, no return would be earned on that money. Hence, different investment methods are useful for investing the saved money in order to earn a return.

Accordingly, investment means any individual investing a certain amount from his/her earned income as savings in an effective method with an intention of earning an economic return.

8.2 Factors to be considered when selecting an investment method

The following factors are considered when selecting an appropriate investment method among different investment avenues.

- The aim of the investment
  Objectives of the investor when investing money
- Risk of the investment
  Whether the invested money could be obtained back and the expected return is certain is considered



Figure 8.1

- Return from the investment
  Whether the return on the investment is sufficient is considered. An individual expects a reasonable return.

8.3 Different types investment methods

The below mentioned are several investment methods.

- Depositing money in a savings account
- Opening a fixed deposit
- Purchasing properties
- Investing in shares
- Investing in treasury bills
- Starting and maintaining one's own business

8.4 Returns of different investment methods

Depositing money in a savings account

As an investment method, an individual can deposit his/her excess money in the savings accounts at banks or at other financial institutions.

You have already studied the characteristics of a savings account and how to open a savings account. The following are the benefits by investing in a savings account.

- Earning an interest income on deposits
- Ability to earn an additional return through gifts or lotteries

Opening a fixed deposit

An individual opening a fixed deposit by depositing a certain amount of money at a certain interest rate for a certain period of time is also considered as an investment method.

You have already studied the characteristics of a fixed deposit and how to open a fixed deposit. The following are the benefit that can be earned by depositing money in a fixed deposit.

- Earning a relatively higher interest rate compared to a savings account
- Ability to withdraw money at maturity or before maturity if required
- Ability to obtain a loan by providing the fixed deposit certificate as a collateral
- Being a safe investment method

Purchasing properties

Investing money to purchase properties such as land, vehicles and houses is also considered as an effective investment method.

An individual can earn following benefits by spending money to purchase such properties.

- Ability to utilize properties by being an owner of properties
- Ability to earn an income by renting or by leasing properties
- Ability to sell properties and obtain cash, if money is required
- Ability to earn capital gains by selling the properties at a higher price than the purchased price
- Ability to present as a collateral when obtaining a loan amount

Investing in shares

The capital of a company could be divided into equal portions and one such portion is known as a share. A company raises capital by issuing shares. When investors buy shares of a company, their money is invested in companies. A company issues different types of shares. Ordinary shares are the most common category among those different types. Investors buying ordinary shares receive an ownership in the company.


Figure 8.2 - Scenery of a share market

Accordingly, an investor becomes an owner of a company by purchasing ordinary shares and receives the voting power when making decisions relating to the company.

The benefit received by investing in ordinary shares are as follows.

The investor has the ability to

- Receive dividends
- Earn capital gains by selling at a higher price than the purchased price
- Sell ordinary shares at any time and obtain cash
- Present as a collateral when obtaining loans
- Appoint directors by voting
- Contribute to the decision making of a company by being appointed as a director

The share market is the market in which shares of companies are issued and traded either through exchanges or over-the-counter markets. Accordingly, when purchased shares from a company are exchanged with others, such market transactions are conducted via the Colombo Stock Exchange.

This is also known as the Colombo Stock Market.

The Securities and Exchange Commission of Sri Lanka

In order to monitor and regulate the transactions of Colombo Stock Exchange the Securities and Exchange Commission of Sri Lanka has been established by an Act of Parliament. The prime objective of this body is to protect the investors by maintaining in a fair manner.

Purchasing treasury bills

Treasury bills are short term instruments issued by the Central Bank of Sri Lanka on behalf of the government in order to fulfill short term financial needs of the government. The Central Bank of Sri Lanka issues Treasury Bills to the registered primary dealers at first. An investor will be able to purchase Treasury Bills from these primary dealers. Often licensed commercial banks act as primary dealers. Treasury Bills are issued with maturity periods of three months, six months and one year.

The characteristics of Treasury Bills and the benefits received by investing in Treasury Bills are as follows.

- Ability to earn an interest income at a fixed rate
- Ability to convert into cash at any time
- A full guarantee from the government is given that the invested money will be paid back

Activity 01

Mr. Kamal Ranathunga is a retired officer of a government corporation. He is to receive his provident fund in due course. He does not have any savings and he does not have any other income generating source as well. He expects to invest his provident fund in an investment method which will provide a reliable and higher monthly income as well as which will ensure the safety of his invested money.

Provide answers to the following questions by analyzing the above information.

01. Suggest an appropriate investment method to Mr. Kamal Ranathunga to invest his provident fund.

02. Explain the reasons for suggesting that investment method.

Activity 02

'It is more beneficial to spend money to purchase properties than depositing money in a fixed or savings account.'

Provide facts to propose on oppose the above statement.

Activity 03

Read the following statements and insert (✓) sign in the most suitable column regarding the accuracy of those statements.

No.	Statement	Ordinary shares	Treasury bills
01	Issued by public limited companies.		
02	Issued by the Central Bank of Sri Lanka.		
03	Dividends are received as the return on investment.		
04	An investment method having complete security from the government.		
05	Can earn an interest income on the investment.		
06	By investing, one becomes an owner of a company.		
07	The return on investment is not at a fixed rate.		
08	Matures within one year or less than that.		

(All the pictures appeared in this book have been downloaded from the internet)